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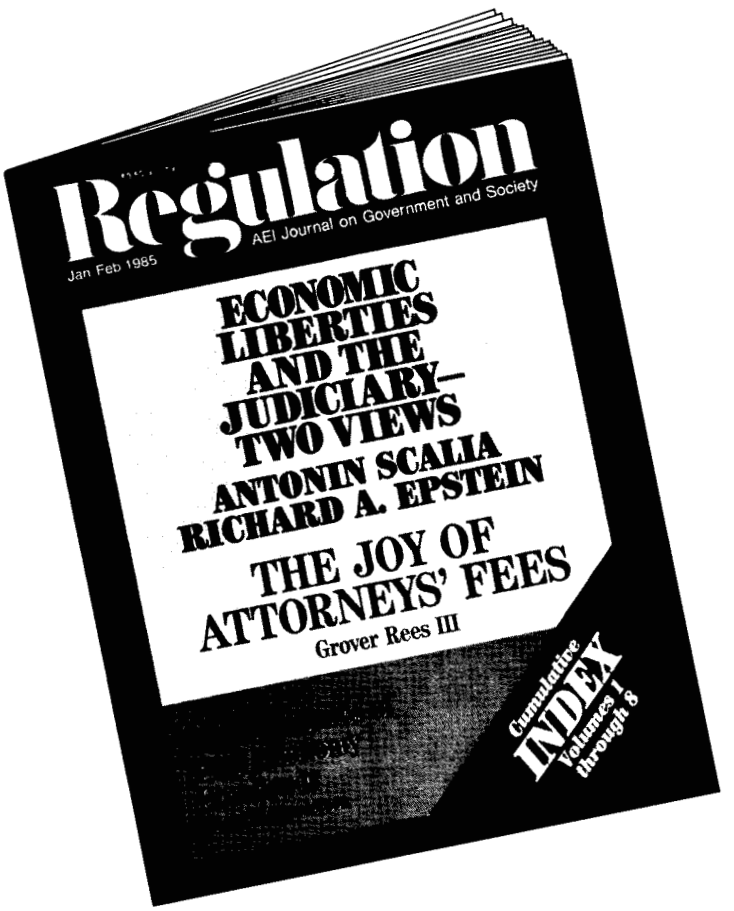
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Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

The Uncertain Case against Acid Rain

TO THE EDITOR:

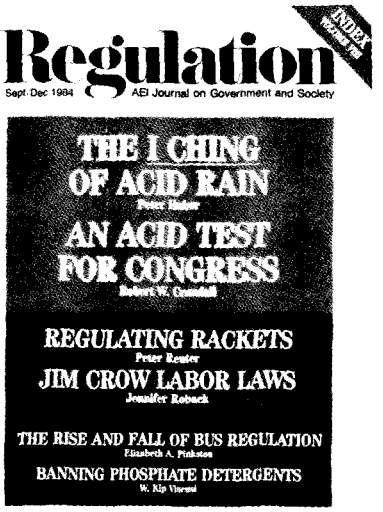
In his excellent article on "The *I Ching* of Acid Rain" (*Regulation*, September/December 1984), Peter Huber suggests that reducing emissions of sulfur dioxide (SO_2) in the United States would not yield proportional reductions in the acidity of rain in the Northeast. I think Huber understates his case. The supposed linkage between sulfate and acidity is much weaker than most people are aware.

Huber notes, for example, that European data for the 1960–75 period showed "significant increases in SO_2 emissions coupled with constant or declining deposition of sulfate." Evidence in the United States shows the same lack of correlation. Part of the case against SO_2 arose from reports that precipitation in the East became markedly more acidic from the mid-1950s to the mid-1970s. However, chemists at the Illinois State Water Survey reanalyzed the data and found that the changes in acidity were not related to the sulfate content of the rain.

In Virginia, for example, the acidity of rain increased by 74 percent during this period, while sulfate concentration *fell* by 3 percent. In Pennsylvania, acidity was up by 216 percent, while sulfate was down by 23 percent. And in Illinois, acidity increased by 27,000 percent, while sulfate increased by only 22 percent. In addition, the National Academy of Sciences' 1983 report notes that SO_2 emissions fell by 38 percent in the six New England states from 1965 to 1978, but there was no long-term trend either way in the acidity of the rain there.

The NAS report also notes that in EPA Region II (New York and New Jersey) SO_2 emissions fell by 40 percent during the period 1965–78; and the U.S. Geological Survey reports that sulfate concentrations in New York state fell by about 30 percent in that period. Again, there was no significant trend either way in the acidity of rain.

It is noteworthy that the Illinois state chemists cited above ascribe the increases in acidity to the marked drop in acid-neutralizing soil particles, which had been abnormally high in the mid-1950s as the result of widespread drought and accompanying dust storms in the Midwest. Another clue as to the role of these soil particles comes from the Geological Survey data that show no significant correlation between sulfate and acidity in New York rain. The same data show a statistically significant correlation ($p > .05$) between acidity and calcium. For six of the nine New York sites, in fact, the correlation is "very highly significant" ($p > .001$), or very unlikely to have been due to chance. Calcium in this case undoubtedly came from the airborne soil particles that form the nuclei of eventual raindrops.



As Huber noted, "trees can also add to soil acidity." Data from studies over the past half century show that this source of acidity is neither incidental nor insignificant. The decayed organic litter on the forest floor creates an active acidity in the humus that is typically five to fifty times stronger than the acidity in the rain. To what extent the acidity of the forest floor is neutralized by the alkalinity of the mineral soil beneath depends on a variety of factors in the forested watershed: the slope of the surface, the kinds and amounts of vegetation, the thickness of the mineral soil layer, its chemistry, porosity, structure, degree of saturation, and so forth.

The intensive four-year-long Integrated Lake-Watershed Acidification Study, conducted under the auspices of the Electric Power Research Institute, documented and measured the role of the forest floor in determining the acidity entering mountain lakes and streams. And the 1984 report of the congressional Office of Technology Assessment said: "Because of the large area of a typical watershed, most of the acid ultimately deposited in lakes and streams comes from water that runs off or percolates through the surrounding land mass, rather than from precipitation falling directly on water bodies. The amount of acidifying material that actually enters a given lake or stream is determined primarily by the soil and geologic conditions of the surrounding watershed."

It is also worth noting that a variety of reviews by competent bodies such as the Interagency Task Force on Acid Precipitation, the OTA report cited above, and the recent Critical Assessment Review report to the Environmental Protection Agency, as well as reports in the peer-reviewed scientific literature, specifically note the absence of confirmed evidence linking the acidity of rain with dead fish, dying trees, or threats to human health. Huber bends over backwards in saying, "The fairest conclusion on the scientific side of acid rain . . . is that for North American conditions, no fair conclusion can yet be reached." It might be more realistic to say that the scientific evidence strongly suggests that the measures proposed to reduce SO_2 emissions will not deliver meaningful benefits to sensitive ecosystems hundreds of miles away. The real problem is

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that the facts have not been adequately aired in the media or in the legislative halls where decisions will have to be made.

Alan W. Katzenstein,
Katzenstein Associates,
Larchmont, New York

Lemon Aid for Car Buyers

TO THE EDITOR:

The article "Can Regulation Sweeten the Automotive Lemon?" (Perspectives, September/December 1984) perpetuates a confusion about when regulation is appropriate in the used-car market. This confusion also helps explain why the scholars you cite, Michael Pratt and George Hoffer, find that state disclosure laws have no effect on the quality of used vehicles.

The used-car market will not work efficiently when sellers have information about the quality of vehicles that potential buyers do not have and cannot gain by inspecting the car. So long as this informational asymmetry persists, the used market may fill up with "lemons" that appear to be good cars but are much more costly to repair than average.

Your article correctly notes that one of the functions of the used-car market is to transfer old and heavily used cars that will require a lot of maintenance to those who value them most highly (students and the mechanically inclined). It is misleading, however, to call an old car a lemon simply because it requires a lot of maintenance, since we would not expect a buyer to be so naive as to expect an old car to be as trouble-free as a new car. A "lemon" should be thought of as a car that will have more breakdowns than the average car of the same age and previous usage.

A market for lemons could be averted by the development of market institutions, such as warranties, that would eliminate the sellers' incentive to misrepresent the quality of used cars. Regulation of the used-car market is another alternative. But an adequate cost/benefit comparison of the two alternatives (regulation and seller guarantees) requires much more information than is available in the data Pratt and Hoffer use. Demonstrating that states with disclosure laws have no fewer lemons on the market than states without such laws does not prove that regulation provides no benefit; conceivably, regulation might rid the market of excess lemons at less social cost than the private warranty mechanisms that may be in operation in states with no disclosure law.

In my study of the market for used pickup trucks, I found no evidence that the market for trucks less than ten years old was dominated by lemons. (The opposite was true for trucks more than ten years old.) Pratt and Hoffer find evidence of a lemons market for younger trucks because they fail to distinguish between classes of trucks on the basis of age or lifetime mileage —pieces of information that are available to buyers and therefore should not form the basis for regulation.

In short, the finding that regulation has no effect should not be surprising. The market for trucks less than ten years old had already been resisting domination by lemons, and regulation could hardly improve on this finding. Presumably trucks more than ten years old are sold mostly by owners who, unlike dealers, are not subject to the regulations.

Eric W. Bond,
Pennsylvania State University

THE EDITORS respond:

We asked Michael Pratt and George Hoffer to reply. They write:

"The difference between Bond's results and ours derives from our different definitions of the market for used vehicles. Bond compared original-owner vehicles with vehicles of the same age and similar mileage that were purchased used at some date. Our analysis compared recently resold vehicles with those that were kept by their owners. Given that there was not a significant difference between the age and mileage characteristics of these groups, the higher repair record of the recently resold group was supportive of the lemons hypothesis. The conflicting conclusions on whether there is a lemons market in used pickup trucks suggest the fragility of the statistical difference obtained from these models.

"We would not expect Bond to be surprised at our finding that regulation of this market seems to have no effect. However, we are perplexed at his characterization of our results. We do not say that regulation in general provides no benefits; we conclude only that a specific regulation, similar to that originally proposed by the Federal Trade Commission, seems to be no more effective than current state commercial codes and existing market institutions. We do not dispute the possibility that there might exist a regulation that might be more effective than the FTC rule, or that the market institutions presently in place may have costs of their own."

Canadian Aerospace

TO THE EDITOR:

I much appreciated your piece on Canadian industrial policy ("'Heavy Landing' for Canadair," Perspectives, September/December 1984). Your readers would profit from an update on the Canadian government's activities in this area.

Recently Ottawa announced that it would purchase twelve unsold Challenger aircraft from Canadair "in order to demonstrate the reliability" of the planes (*Le Devoir*, Montreal, March 6). This rationale seems dubious, since eight of the planes are used Challenger 600s (a discontinued line) that were returned by their owners. A more plausible explanation is that the government is trying to prop up Canadair's balance sheet by boosting its cash level and cutting its inventory of unwanted planes so as to make privatization more feasible. Needless to say, the government paid full price for the planes.

Moreover, a new "Canadair" is in the works—not surprisingly, since the very idea of an "industrial policy" leads to more and more instances of rent-seeking. The Trudeau government decided in 1982 that Canada should get involved in the helicopter industry in a big way. Together with the Quebec government, it proceeded to grant Bell Helicopters, Inc. (a subsidiary of the American company Textron) $275 million to build a plant at Mirabel airport, fifty kilometers north of Montreal. (Mirabel, opened by the Trudeau government at great cost in the 1970s amid protests that it was unnecessary, is the world's largest airport, and one of the least used.) Depending on the exchange rate used, up to 79 percent of the plant's capital costs are being paid by taxpayers. To lure the plant to Quebec, the provincial government waived the *French Language Charter* so as to allow the children of incoming Bell employees to be educated in English. It also overruled the decision of its Quebec Agricultural Land Zoning Commission, which had forbidden construction on the Mirabel site.

(*Continues on page 32*)

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Perspectives
on current developments

A Truce in the Takeover Wars?

To a casual observer, hostile corporate takeovers may seem as pointless and destructive a form of modern warfare as the Iran/Iraq conflict. "Raiders" strike with bear hugs, junk bonds, and two-tier tender offers. Incumbent managers respond with poison pills, greenmail payments, shark repellents, and golden parachutes. Congress is wearying of the strife, and may soon impose a cease-fire on the combatants —but to whose benefit?

Last term, Representative Timothy Wirth (Democrat, Colorado) introduced H.R. 5693, the "Tender Offer Reform Act of 1984," which would have made a number of changes in the law governing takeovers:

- Once a buyer had acquired 5 percent of a target firm it would have to cease acquiring stock for two days, unless the Securities and Exchange Commission gave an earlier go-ahead. It would also have to file a public notice with the SEC—and thereby alert the target's management—within twenty-four hours of the purchase. (Currently the Williams Act allows ten days to file such a notice.) If it proceeded to seek control of the target through a tender offer, it would have to keep the offer open for forty calendar days (current regulation requires twenty business days).
- Furthermore, a buyer would have to notify the SEC in a public filing of its intentions "to make any major change which would affect the communities in which [the target] operates . . . [or] which would substantially affect its management, labor organizations, or employees." Existing law requires the buyer to notify the SEC of its background, of whether it intends to acquire control of the business, and of many other factors, but does not require the filing of a "community impact statement."
- The bill would also restrict a variety of defensive tactics by target management. During tender offers, target companies would be forbidden from issuing "golden parachutes," which provide big severance payments to executives displaced by a hostile acquirer. And takeover targets would not be allowed either to issue major new blocks of voting securities (so as to dilute the value of the offeror's shares) or buy back chunks of shares (so as to keep them away from the offeror) without the approval of a majority shareholder vote. Companies would also be prohibited from making "greenmail" payments to raiders (buying out their holdings at a substantial premium to get them to go away) without affirmative shareholder approval. Such repurchases have angered stockholders who do not share in the greenmail premiums, and who often see the value of their shares decline sharply when the greenmail recipient withdraws from the bidding.

H.R. 5693 was sent to the floor by the House Energy and Commerce Committee, but was withdrawn in the closing days of the session. Similar proposals were introduced in the Senate, and are likely to be introduced again this term. Reaction has been mixed. Last year the SEC supported restrictions on many takeover tactics, but it now seems to have stepped back from any endorsement of further federal tinkering. The Treasury Department broadly warns against restricting takeovers "in the name of fairness to shareholders, [when] those same shareholders are the ones who benefit from such activities," and says it finds "no systematic evidence that takeover activity has done anything other than increase national wealth and improve efficient allocation of corporate resources."

Some critics of takeovers decry them as part of a trend toward "paper entrepreneurism." Recent scholarship, however, suggests that they serve a productive purpose. A 1983 article in the *Journal of Financial Economics*, surveying economic studies of the market for corporate control, concluded that both bidders and targets realize positive returns from suc-

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cessful takeovers. That shareholders of the target firm earn a profit is no surprise, since raiders invariably offer a premium for the shares they buy. Even the threat of a takeover may spur existing managers to work harder to increase the value of their stockholders' shares. To some, perhaps, more surprisingly, the shareholders of the raider also benefit in the long run. Takeovers allow worse managers to be replaced by better, and generate the other sorts of productive efficiencies associated with mergers. So why the sudden rush to regulate?

The House committee report on H.R. 5693 recognizes that takeovers can produce economic benefits, but says they may also "result in the loss of jobs, cause management to focus upon short-term stock performance instead of long-term prospects, and reduce the amount of credit available for other productive purposes." These complaints are familiar. The spectre of job loss (and its related spectre of disruption to communities) is also invoked to argue against mergers and foreign imports; in both cases the prospect of reduced labor inputs looks suspiciously like the flip side of the opportunity for greater efficiency (and more jobs in other communities or businesses). As for the effect of takeovers on credit demand, it is wrong to imagine that a takeover will cause a "lump of credit" to vanish forever from the capital market; when shareholders of the target firm are paid off, the capital will flow back into the market. Takeovers may tie up small amounts of capital for a few weeks, but the banks and other financing parties appear to consider this more productive than the alternative uses they might have for the money. And the fear that takeovers trap management into "short-term thinking" assumes that by maximizing reported short-term profits, management succeeds in deceiving shareholders as to the long-run prospects of the company. If shareholders are well informed, after all, they will discount and capitalize poor long-term prospects in the current price of the stock, which will promptly penalize management for short-sighted decisions. The fear of takeover gives management an incentive to improve reported results in deceptive ways, but so do many other pressures.

A different line of argument holds that while takeovers in general may be efficient, it is abusive for different groups of stockholders to receive different prices for their stock. This would imply banning not only "greenmail" but also "two-tier" tender offers, in which the acquirer offers a high price (or cash) for a controlling block of stock, and a low price (or securities) for the remaining minority shares. These offers, it is said, can stampede shareholders into accepting inferior offers for fear of being locked into a minority position. But an SEC study suggests that banning two-tier offers might actually harm target shareholders by reducing the overall number of tender offers. Although shareholders might in theory get higher premiums when single-tier offers were made, fewer offers would be made—and fewer premiums paid—in the first place.

Robert Reich has argued that managers are distracted from business affairs when they concentrate on fending off a hostile invader. But managers are never forced to defend their incumbency; they can simply stand aside and let the shareholders decide. To be sure, takeover offers sometimes provoke incumbent managers into taking "poison pills" whose effect is almost certainly to harm shareholders. The remedy that suggests itself, however, is to put restrictions on the incumbents, not the raiders.

But although a stronger case might be made for restricting defensive tactics, here too there are doubts that a legislative solution would work. Treasury points out that it would be hard to draft a law that restricted abusive defensive tactics without interfering with perfectly legitimate business activity. The SEC has suggested that if filing a tender offer were to trigger sweeping restraints on target management, raiders might have a better blackmail tool than ever: threatening to tie up the targets' operations with below-market offers. Federal Trade Commission Chairman James C. Miller III has said that although he supports the principle of a law to control abusive defensive tactics, he would prefer simply to even the playing field by removing existing restraints on bidders.

Another consequence of the congressional proposals to restrict defensive tactics, and further to restrict takeovers, would be to extend federal law into areas traditionally left to state and marketplace regulation. State courts (and federal courts interpreting state law) decide corporate governance issues through case-by-case adjudication. The "business judgment rule," under which courts will not second-guess management decisions that can be attributed

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In Brief–

Crackdown on Low Prices. Despite the widespread view that railroads and truckers are being deregulated, the Interstate Commerce Commission continues to pester carriers and shippers for agreeing to excessively low rates. In March the commission acted to resolve a complaint from its enforcement arm seeking treble damages against two railroads and a shipper for an alleged undercharge.

At issue was what happens when a railroad ships hazardous materials to a customer that is not yet ready to unload them. "For obvious reasons," as commissioner Frederic Andre says, "railroads prefer not to hold such cars in their switching yards any longer than necessary." Thus the railroad shunts the cars to a side track on the receiver's property until the customer is prepared to unload them. ICC officials had long given informal assurances that since the railroad conducts the shunting movement for its own benefit, it does not have to charge the customer an extra fee to cover the separate movement.

The commission's enforcement arm, which is whimsically named the Office of Compliance and Consumer Assistance, sought to overturn this practice in its complaint. In March the full commission agreed with the railroads and shippers that the practice could continue, but OCCA continues to question alleged undercharges elsewhere. "It is little wonder that the Interstate Commerce Commission is sometimes perceived as anti-shipper," wrote Commissioner Andre, "when our enforcement agents are spending a substantial portion of their budget to harass shippers for allegedly paying too little for transportation, even when both shipper and railroad have agreed that the correct charges were paid."

Goodbye, Mr. Chips. A key element of the ICC's retreat from deregulatory activism, according to commission insiders, has been its gradual but systematic elimination of reformers' staff positions. The agency's Office of Transportation Analysis, a one-time hotbed of pro-competition advocacy, has come under particular pressure. It would be cut from forty-one to thirty positions if the Senate adopts the recommendation of its Appropriations Committee. "Though this office might serve to inform the Congress and the public about the implications of deregulation and the current economic status of the various activities monitored by the Commission, it has rather served to promote further deregulation by administrative fiat," says the report by the subcommittee that oversees ICC funding—which is headed by Senator Mark Andrews (North Dakota), a Republican who has been critical of deregulation.

Twinkle, Twinkle. In one of the more unusual ventures in the commercialization of outer space, entrepreneurs are planning to launch human ashes into orbit. The promoters hope to use shiny spacecraft so that bereaved earthlings could more easily view the departed.

In a letter to the editor of *Science,* Jan Beyea of the National Audubon Society warns that this is "the beginning of a new visual form of pollution, the cosmic equivalent of billboards on highways." A resourceful advertiser, Beyea sug-

to any rational business purpose, has traditionally afforded corporate managers virtual carte blanche, absent a showing of self-dealing. To some, this suggests that the competition among states like Delaware and Nevada to supply corporate law has led to a "race to the bottom" in providing shareholder protection. To others, it suggests that the market has fixed on better ways to control managerial self-interest or incompetence than judicial oversight, whether through provisions in corporate charters, contracts with managers (including stock options and other incentive arrangements), or simply the discipline of stock pricing.

In a recent decision (*Norlin Corp.* v. *Rooney Pacé, Inc.* 1984), the U.S. Court of Appeals for the Second Circuit suggested that management decisions about the use of defensive tactics in takeovers will be scrutinized more closely than in other contexts. This parallels the heightened judicial scrutiny that is traditional in other areas where executives have a conflict of interest or self-dealing is likely. The committee report on H.R. 5693 hailed the *Norlin* decision, but warned that "it will continue to monitor this area of law carefully to determine whether legislation is warranted," and in fact Wirth has filed preemptive federal legislation (H.R. 5695) to alter the business judgment rule.

However, the lobbying for restraints on raiders is stronger than for restraints on targets, with business executives leading the charge against the hostile takeovers that so often cost them their jobs. In an August 1984 Louis Harris survey, about two-thirds of senior corporate executives polled said that hostile takeovers were bad for the economy (but non-hostile acquisitions good), and 70 percent thought that the bidder has "the advantage," presumably an unfair one, in a takeover battle. A majority of the executives would ban two-tier

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gests, could launch dozens of reflective objects arranged so as to form letters or words. "Twenty years from now, will we walk out at night to see the word "Coke" emblazoned in the sky?"

Not if the regulators can be mobilized in time. "Congress should extend the authority it has given the Department of Transportation to regulate private launches and allow it to limit the brightness of private space payloads—a 'Space Beautification' addition to the Commercial Space Transportation Act."

All Quiet on the Pork-Barrel Front. Last year the Pentagon spent almost $75 million to buy and ship American coal to U.S. bases in Europe—mostly anthracite, the type of "hard coal" whose use has been in long-term decline. Members of Congress from Pennsylvania have succeeded in passing appropriations riders requiring the Defense Department to pass up cheaper European suppliers in favor of the U.S. product. Recently, Congress directed the Pentagon to build up an unwanted one-year stockpile of U.S. coal in Europe.

The army would prefer to hook up to German utility systems for its heating needs, but anthracite industry spokesmen have argued that switching "would make our bases dependent on German municipalities," in the words of a report in *Common Cause* magazine. Unfortunately, such dependence will not go away no matter where the coal comes from: the coal boilers themselves need water and electricity to operate, and municipal German utilities are the sole suppliers of both.

Prometheus Unbound. There are signs of a "new-found aggressiveness" at General Motors, our number one auto maker, according to a *Wall Street Journal* article. Since taking office in 1980, Chairman Roger B. Smith "has transformed GM from a shrinking, bureaucratic giant into an organization in which the only constant is change." The company has begun expanding in nonautomotive areas and experimenting with sophisticated new production techniques.

"Mr. Smith portrayed himself as making changes his immediate predecessors couldn't because they had to direct their executives' energies toward solving problems imposed by government regulations, particularly those relating to safety, fuel economy and pollution control," the *Journal* account says. "Now that most of those regulatory problems have been solved and deregulation is in vogue, Mr. Smith believes he can focus his subordinates' efforts on expanding GM's business."

For many businesses, the freeing of executives' creative energies must be the single most important benefit from deregulation. Unfortunately, it is a benefit that is nearly impossible to quantify in regulatory impact or cost-benefit analyses.

Man Bites Dog. It finally happened. A government decided to remove the beam from its own eye before complaining about its neighbor's mote.

Prime Minister Brian Mulroney of Canada said February 1 that he would restrain his criticism of U.S. inaction on acid rain until Canada "cleans up its own act." Mulroney added that "we have to stop blaming them exclusively" and that "in point of fact we are behind the Americans in emission control in many significant areas." Policy observers are now on the lookout for such unexpected events as a month of Sundays, a blue moon, and the freezing over of Hell.

---

tender offers and greenmail, require 5 percent buyers to inform the target management immediately, and require 20 percent holders to make a tender offer for the remaining shares. Not surprisingly, these numbers are reversed when restraints on target management are at issue. Over two-thirds of the executives oppose restricting the amount of its own stock a target company can reacquire to block takeovers, over half oppose outlawing golden parachutes, and a plurality reject restrictions on stock dilution by targets. Harris sums it up: "What executives really want is for the acquirer to be hemmed in, but not themselves."

Interestingly, 80 percent of the executives agreed that ordinary shareholders do "very" or "moderately" well in both friendly and hostile takeovers. On average, target company shareholders appear to earn premiums in excess of 30 percent. No poll has been taken on whether shareholders are eager to give up these gains.

Even if the agreed-on aim were genuine neutrality between bidders and targets, it is doubtful that new federal legislation could achieve that goal. Consider the history of past federal forays into corporate regulation—all of which have resulted in controls on bidders, not incumbent managements. The Williams Act was intended to be neutral, but in practice it brought about an immediate and substantial reduction in the number of tender offers (a 40 percent reduction in the year after passage), which did not return to previous levels for nine years. This is hardly surprising: one key to a successful takeover attempt is to strike quickly, before the incumbent management can mobilize a defense, and the Williams Act delays the process.

The Williams Act did not restrict open market purchases of stock, which became increasingly popular as a takeover tool. By the mid-1970s, the traditional tender offer looked so unattractive by comparison that some were

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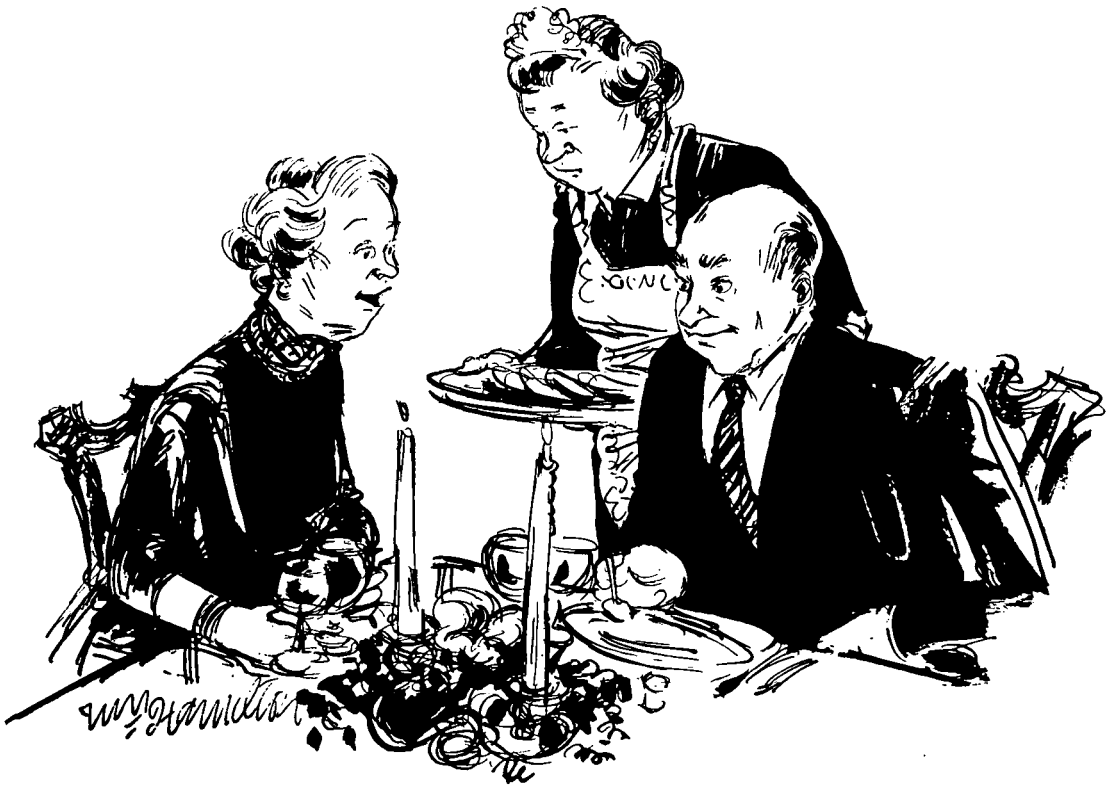

"I knew it! Whenever you absorb a company, you get so perky!"

Drawing by William Hamilton; © 1980 The New Yorker Magazine, Inc.

predicting large-scale shifts to open market purchases as the favored takeover method. Then the Hart-Scott-Rodino Antitrust Improvements Act of 1976 came along, imposing "waiting periods" on large stock purchasers that were longer than those the Williams Act imposed on tender offerors. The stated intent of the 1976 law was to give the FTC and Justice Department time to decide whether to challenge major acquisitions on antitrust grounds. But by taking away the advantage of open market purchases over tender offers, it may have unintentionally prevented a dramatic evolution in takeover tactics.

In the end, however, the decisive issue in the current debate may have nothing to do with the offensive/defensive balance. Underlying many takeover discussions—sometimes openly, sometimes not—is the question of merger policy. Corporate takeovers often, though not always, lead to corporate mergers—whether the target firm falls to the "raider" or the "white knight." The activities of T. Boone Pickens, for example, led to two of the largest mergers in history by driving Gulf Oil into the arms of Chevron and Cities Service into the arms of Occidental Petroleum. Although government policy and academic opinion have both shifted dramatically toward a more favorable view of mergers in recent years, old-fashioned trustbusters remain unconvinced. (A piquant irony is that the "bust-up artist," who specializes in splitting his targets into smaller companies, is universally despised even though he accomplishes deconcentration at a profit.)

The drive to regulate takeovers may afford the opponents of industrial concentration a chance to regain through regulation of the securities market the ground they have lost in antitrust policy. The Hart-Scott-Rodino Act sought to regulate mergers and wound up regulating takeovers. It would not be unprecedented for takeover legislation—by intention or not—to wind up effecting significant changes in merger policy.

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Regulation and the 1986 Budget

The books have now been closed on four years of Reagan administration budget policy in the regulatory area, and we can therefore assess how things have changed, if at all, in the course of the 1981–84 period. In brief, the Reagan budgets to date show a trend toward a different allocation of spending among federal regulatory agencies, but not a lower overall amount. That may change in the future, as the administration appears ready to revive once again its push to cut spending by federal regulators.

The summary figures shown here are adapted from the annual roundup of regulatory agency budgets and staffs prepared by the Center for the Study of American Business at Washington University in St. Louis. They include final regulatory budget figures for the past two fiscal years, together with the administration's projections for 1985 and budget proposals for fiscal 1986. It should be noted that this year's figures from the CSAB are not comparable to those summarized in this space in earlier years. The main difference is that the dollar figures now cover obligations rather than outlays.

The explosive growth in spending by the federal regulatory bureaucracy during the 1970s has been contained. But it has not been reversed. From the last year of the Carter presidency to the last year of Reagan's first term, total federal employment by regulatory agencies has declined significantly, by about 14 percent overall. Apparently this reduction in employment has been more or less offset by increases in outside contracting or by in-house cost inflation, however, because total spending measured in constant dollars has not changed much.

This apparently level trend over a four-year interval in fact masks a V-shaped pattern in between. Spending dropped precipitately in the first full Reagan budget (for 1982), but in the succeeding three years it inched steadily back up to the 1980 levels. If current estimates hold, federal regulatory spending in 1985, the last budget year in Reagan's first term, will almost exactly match real-dollar regulatory spending for 1981, the last budget year from the Carter administration.

There have, however, been some significant shifts in where the federal regulatory dollar is being spent. In constant dollars, expenditures for "social regulation"—such areas as consumer and occupational safety and health, energy, and the environment—fell about 6 percent between 1980 and 1984. In the same period, expenditures for "economic regulation"—finance and banking, regulation in such specific industries as communications and commodities, and general business regulation in such areas as securities and patents—rose about 10 percent. This shift in regulatory priorities appears to be continuing in 1985, with the budget fraction allocated to economic regulation creeping up from about 18 to about 19 percent of the total.

For 1986 the administration has announced its intention to stop shuffling the regulatory deck and begin cutting it once again. It plans no significant further shift in spending from social to economic regulation, but does propose cuts in overall spending. In nominal dollars, the 1986 budget for federal regulation amounts to something just under a freeze: total expenditures are slated to decline, overall, by about 0.3 percent. In constant dollars, however, the budget represents a cut roughly equal to the rate of

EXPENDITURES ON FIFTY-SIX REGULATORY AGENCIES
Selected Fiscal Years, 1970–86

Area	1970	1980	1983	1984	1985 (est.)	1986 (est.)
	EXPENDITURES ($ billions)					
Social Regulation						
Consumer Safety & Health	$ 0.9	2.8	2.9	3.1	3.3	3.1
Job Safety & Other Working Conditions	$ 0.1	0.8	0.8	0.8	0.9	0.8
Energy & the Environment	$ 0.3	2.2	2.3	2.7	3.1	3.2
	$ 1.3	5.7	6.0	6.6	7.2	7.2
Economic Regulation						
Finance & Banking	$ 0.1	0.4	0.5	0.8	0.9	0.8
Other Industry-Specific	$ 0.1	0.3	0.3	0.3	0.3	0.3
General Business	$ 0.1	0.4	0.4	0.5	0.5	0.5
	$ 0.3	1.1	1.3	1.5	1.7	1.7
TOTAL	$ 1.6	6.8	7.3	8.2	8.9	8.9
TOTAL IN 1972 DOLLARS*	$ 1.7	3.8	3.4	3.7	3.8	3.7
	PERMANENT FULL-TIME POSITIONS (thousands)					
Social Regulation	65.5	103.6	88.6	87.8	88.4	86.8
Economic Regulation	19.9	27.8	25.4	25.6	25.3	25.5
TOTAL	85.4	131.5	114.0	113.3	113.6	112.3

*Adjusted by GNP deflator (actual and, for later years, estimated in budget).
Source: Adapted from figures of the Center for the Study of American Business.

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CHANGE IN EMPLOYMENT FOR TWENTY-EIGHT REGULATORY AGENCIES

Agency	Permanent Full-Time Positions 1984	1985 (est.)	1986 (est.)	Percent Increase (Decrease) 1984–86
Consumer Product Safety Commission	558	567	549	(1.6)
Food & Drug Administration	7,168	7,084	6,893	(3.8)
National Highway Traffic Safety Administration	640	640	705	10.2
Bureau of Alcohol, Tobacco & Firearms	3,038	3,038	3,016	(0.7)
TOTAL, *Consumer Safety & Health*	11,404	11,329	11,163	(2.1)
Mine Safety & Health Administration	3,271	3,107	2,977	(9.0)
Occupational Safety & Health Administration	2,355	2,323	2,280	(3.2)
Equal Employment Opportunity Commission	3,125	3,125	3,125	—
National Labor Relations Board	3,213	3,000	3,000	(6.6)
TOTAL, *Job Safety & Other Working Conditions*	11,964	11,555	11,382	(4.9)
Economic Regulatory Administration	377	325	310	(17.8)
Office of Surface Mining	849	906	898	5.8
Environmental Protection Agency	10,141	11,473	12,042	18.7
Nuclear Regulatory Commission	3,332	3,351	3,351	0.6
TOTAL, *Energy and the Environment*	14,699	16,055	16,601	12.9
Comptroller of the Currency	3,250	3,250	3,250	—
Federal Deposit Insurance Corporation	3,554	3,554	3,554	—
Federal Home Loan Bank Board	1,327	1,335	1,330	0.2
National Credit Union Administration	384	386	392	2.1
TOTAL, *Finance and Banking*	8,515	8,525	8,526	0.1
Civil Aeronautics Board*	363	—	—	(100.0)
Commodity Futures Trading Commission	557	567	567	1.8
Federal Communications Commission	1,976	1,822	1,849	(6.4)
Federal Energy Regulatory Commission	1,564	1,662	1,587	1.5
Federal Maritime Commission	232	240	215	(7.3)
Interstate Commerce Commission	1,023	844	894	(12.6)
TOTAL, *Industry-Specific Regulation*	5,715	5,135	5,112	(10.6)
International Trade Commission	1,023	844	894	(12.6)
Patent & Trademark Office	3,286	3,438	3,408	3.7
Antitrust Division**	704	649	649	(7.8)
Federal Election Commission	225	232	230	2.2
Federal Trade Commission	1,160	1,145	1,101	(5.1)
Securities & Exchange Commission	2,021	2,046	2,060	1.9
TOTAL, *General Business*	8,419	8,354	8,342	0.8
TOTAL, TWENTY-EIGHT AGENCIES	60,716	60,953	61,126	0.7

*Abolished in 1984.

**Included in earlier years under the heading "Social Regulation."

Source: Adapted from selected figures of the Center for the Study of American Business.

inflation—about 4 percent. This is not as large a drop as the 10 percent cut in fiscal 1982, Reagan's first budget, but it is a bigger drop than has been seen before or since.

Some of the more notable losers for 1986 include the Federal Railroad Administration, down 18 percent; petroleum regulation in the Department of Energy, down 17 percent; the Office of Surface Mining Reclamation and Enforcement, down 17 percent; the Animal and Plant Health Inspection Service, down 12 percent; and the Civil Aeronautics Board, down and out at zero. Among the winners are the Drug Enforcement Administration, up 64 percent; the International Trade Administration, up 29 percent; and the Environmental Protection Agency, up 12 percent. (All percentages are calculated from nominal dollar figures.) Losers outnumber winners almost two to one, but the gains of a few big winners (most especially the $2 billion Environmental Protection Agency) manage to hold the overall regulatory market fairly steady at just under $9 billion.

And what of the *real* market outside Washington? No one truly knows. For industries vetted by agencies such as the Occupational Safety and Health Administration (down 4 percent) or the Consumer Product Safety Commission (down 6 percent), a smaller agency budget will presumably mean fewer inspections or recalls, fewer new standards—in short, less regulation. But for industries whose activities are screened by agencies that license new products and technologies—agencies such as the Nuclear Regulatory Commission (down 6 percent) or the Food and Drug Administration (down 5 percent)—a smaller regulatory budget may in fact mean either more or less regulation, depending on where the cuts come from. The

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agency could react to the cuts in ways that slow down approval, leaving the licensing more clogged and impenetrable than ever, or it could take down some of the hurdles that keep its examiners busy. In the end, the true "regulatory budget" depends little on how much is spent directly by Washington regulators. What matters is how much the rest of the country spends in trying to appease them—and what, if anything, the country gains in return.

Bumpers to Bumpers in Court

Veterans of the last decade's regulatory debates will recall the Bumpers amendment as a perennial passenger on the omnibus of congressional regulatory reform. The amendment had to do with how judges should behave when they scrutinize regulatory activity. Now, confusingly, along comes the bumpers *decision*, which deals with some of the same issues of judicial review of regulation. This time "bumpers" refers not to the senator from Arkansas but to the small-"b" kind on automobiles.

Congress may have abandoned its search for an omnibus regulatory reform package as irrelevant or politically unachievable, but the underlying controversies persist: how complete a factual basis must agencies establish before they regulate? Can the White House interfere with agency actions? What can Congress do to make its wishes known? How deferential should judges be toward the agency when the controversy winds up in their laps? And should the standards differ when deregulation—the repeal or revision of existing rules—is at issue? The Supreme Court's landmark air-bag case last year addressed each of these questions, and the appeals court's bumpers decision this January carries the analysis along another step.

In 1971 the National Highway Traffic Safety Administration, relying on a 1966 law, issued a rule requiring that automobile bumpers be built to withstand an impact of five miles per hour in front and two-and-a-half mph in back without damage to the vehicle's "safety systems"—its lighting, fuel, exhaust, cooling, or latching components. Another part of the standard effectively required bumpers to be built at a standard height. The idea was to prevent damage to head and tail lights during collisions and also "bumper interlocks," which could tie up traffic and force drivers to dart into traffic to disentangle them.

As time went on NHTSA added elaborations to the rule, especially after a 1972 law (the Cost Savings Act) gave it new powers to combat economic losses to consumers as well as injuries. The standard for rear bumpers was increased step-wise until by the 1973 model year they too had to survive a five mph crash. Then the agency began requiring that the bumper be strong enough to protect all the rest of the vehicle from damage in five mph crashes. Eventually even the bumper was permitted to incur only minimal damage.

When the agency first issued the rule, it simply assumed that protecting the integrity of a car's safety systems in minor accidents would help prevent subsequent accidents. Not until later did it begin conducting tests and developing empirical evidence to test this hypothesis. A 1979 analysis concluded that the five mph standard gave consumers a net benefit of $39 compared with the two-and-a-half mph standard. But that report came under criticism, and the numbers were later reduced to a range of $11–29. And a long-term study released by the agency in 1981 indicated that the five mph front standard was of only borderline cost-effectiveness, and the five mph rear standard clearly was not cost-effective.

Not long after taking office, the Reagan administration announced that as part of its promise to help the auto industry out of its financial morass NHTSA would propose a modification of the bumper standard. The agency proceeded to issue a new rule reducing the standard at both ends from 5.0 to 2.5 mph, lowering the crash velocity that the corners of a car had to withstand, and eliminating the requirement that the bumper itself not suffer damage in minimal collisions.

The usual plaintiffs—insurance companies and their allied associations, along with the Nader-founded Center for Auto Safety—went to court to challenge the rollback. On January 5 of this year a three-judge panel of the U.S. Court of Appeals for the District of Columbia upheld the agency by a two-to-one majority (*Center for Auto Safety* v. *Peck*.) The court has just denied a rehearing *en banc*.

The majority and the dissent agreed that the correct standard of review to apply was that

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enunciated by the Supreme Court in the air-bag case (*Motor Vehicle Manufacturers Association* v. *State Farm Mutual,* 1983). There the Court rejected the argument advanced in this space that an agency should have wider latitude in pruning back or eliminating old regulations than in adopting new ones (see "Active Judges and Passive Restraints," Perspectives, *Regulation,* July/August 1982). The Court acknowledged that agencies need to adapt their regulations to changing circumstances, but reasoned that

> the forces of change do not always or necessarily point in the direction of deregulation. In the abstract, there is no more reason to presume that changing circumstances require the rescission of prior action, instead of a revision in or even the extension of current regulation. If Congress established a presumption from which judicial review should start, that presumption . . . is not *against* safety regulation, but *against* changes in current policy that are not justified by the rulemaking record. [Emphasis in original.]

In short, regulations are like numbers in algebra: there are positive and negative varieties but the applicable operations are the same. The presumption of the Administrative Procedure Act is not in favor of citizen autonomy, but in favor of the status quo—whether unregulated or regulated.

If that were all there were to it, the inquiry would have been done. But there is more to the story.

Under the general principles of administrative law, an agency's choices in issuing a regulation are bounded by the statute under which it operates and the record developed during the rulemaking proceeding. The agency must examine the relevant data on the record and articulate an adequate explanation for its action that includes a "rational connection between the facts found and the choice made," as the Court put it in the air-bag case. But since the statute and the record rarely converge to permit of only one possible interpretation, the agency normally retains a range of discretion. The choice of a particular regulation within that range belongs to the agency and is governed by politics, not law.

The first major question in the bumpers case was what the relationship is between the range of discretion in the first proceeding and the range of discretion in the second. Are the two ranges coextensive, or does the agency's choice in the first proceeding constrain its choice in the second—and if so, how?

To the appellants, and possibly the dissent (the interpretation is unclear), the agency's first decision strongly constrained its second. To abandon its first policy, the agency had to muster outright proof that the change would not reduce safety. It was not clear that NHTSA had shouldered this burden. Its own data, along with that submitted during the rulemaking proceeding, did not convince the agency that there was any measurable difference in the accident rate between the two standards. (A vice-president of one of the appellants admitted that it was an area where you "have to put some judgment on.") But, of course, failing to uncover evidence of harm is not the same thing as proving no harm.

The major importance of the decision lies in the court's finding that although the agency had to justify the change, it did not have to sustain the burden of proof. The decision held that the agency's

> justification need not consist of affirmative demonstration that the status quo is wrong; it may also consist of demonstration, on the basis of careful study, that there is no cause to believe that the status quo is right, so that the existing rule has no rational basis to support it.

Applying the principle of the "hard look," in which the court delves deeply into the record to determine whether the agency's choice was arbitrary or capricious—that is, outside the range of available discretion—the court examined the record in minute detail and found that the agency had carried out that demonstration.

At first glance, the court's principle would seem to create an asymmetry between regulation and deregulation. After all, an agency must marshal affirmative evidence to justify an original regulation. Doubt is not enough. The Occupational Safety and Health Administration surely could not announce that since it had no reason to believe that a given chemical was safe, it was going to ban it.

The asymmetry, however, is only apparent. Revision or repeal, unlike the original regula-

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Viewpoint

Walter B. Wriston

Microseconds and Macropolicy

On January 8, 1815, Andrew Jackson's army defeated the British at the Battle of New Orleans. What makes the battle particularly noteworthy is that it was fought more than two weeks after the signing of the Treaty of Ghent had ended the war. A great many men died because a sailing ship carrying news of that treaty did not arrive in time to prevent the battle.

Today we routinely watch our secretary of state on live television as he steps off his plane in distant capitals and delivers his views on world problems. The implements of war have also changed. Our "fir-built frigates," the world's fastest in 1812, have been replaced by ICBMs that cross the ocean in twenty-odd minutes.

The flow of real-time information about political, military, and economic events is now both routine and prolix. But is our government organized to deal effectively with what can only be described as a new situation in the world? At this point in our national development we do not seem to have in place the structure to formulate policy on information flows —especially their global aspects—let alone to implement it. Indeed, we have given relatively little thought even to understanding what kinds of policy problems we are dealing with, and what vital interests may be at stake for America. This is not an unusual posture in the long history of governments' reactions to technological revolutions.

Revolution and Reaction

Each new age of technology has affected old power structures and changed the political landscape. When a man's wealth was expressed by the amount of land he owned, the sovereign, no matter how bad his economic or political policies, did not have to worry about the flight of capital. You literally could not move the farm. Then the invention of money and the development of industrial and service economies made capital mobile. And the invention of the railroad profoundly changed our society because, among other things, for the first time it gave real mobility to labor. Men and women could escape a harsh working environment for a better one. As goods and people moved across the land toward better opportunities and new markets, the railroad track became the iron strap that bound whole continents together.

Following close on the heels of the railway came a second revolutionary technology, the automobile, which once again dramatically changed the way we live and work. In 1947, William Harlan Hale wrote a layman's history of the United States that illuminated the automobile's role in transforming society in a manner few history books do:

> The car made for private freedom, and especially for the kind of freedom which the arbiters of taste and enjoyment in the big cities were not promoting. . . . It was a declaration of independence against every form of rigid and ancestral control: against the inflexible railroad, against the self-enclosed little community, against the paternalistic family, and against all the inbred customs that had survived from a slow-moving earlier day into the age of speed and power.

Unsurprisingly, every great technological revolution in history has made the ruling classes nervous, because they sensed—correctly —that somehow their power was being undermined. Sovereigns reacted to the new mobility of capital by inventing exchange controls. The railroads were locked into the grip of govern-

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ment regulation until their number and power dwindled as their monopoly eroded through the competition of trucks, barges, and airplanes. While governments regulated transportation, most if not all of them created a monopoly on the delivery of letters. Some say the Stuart kings created the government postal monopoly in order to censor the mail of dissidents.

As new means of communication came along, governments reacted with caution. The Royal Post of England took over the telephone from private hands and slowed its development down to a walk. In 1879, Sir William Preece, the chief engineer of the British Post Office, testified in the House of Commons that the telephone had little future in Britain. "There are conditions in America which necessitate the use of such instruments more than here. Here we have a superabundance of messengers. . . . The absence of servants has compelled the Americans to adopt communications systems." America was lucky: although we set up a government postal monopoly, we did not let it take over our telephone service.

Information Comes of Age

The first computer was probably designed by Alan Turing in England in 1943 to help crack the Nazi ciphers. It was called Colossus and employed some 2,000 vacuum tubes as digital on-off switches. At about the same time two Americans were also at work for the U.S. Army building a computer called Eniac. It had more than 17,000 tubes and was designed for calculating trajectories of shells and missiles.

From this wartime effort we have moved through various phases to the current microcomputers that have now been married to telecommunications to produce something new under the sun. The onrushing age of information technology gives a whole new dimension to the sovereign's worry about loss of control over men and money. Just as the automobile changed our society in ways that are still unfolding, so today, the third great revolution—the rise of the information society—is affecting the way we live and work.

In the past, machines were inflexible, in the sense that the user had to adapt his uses to the function of the machine. A drill press, for example, could only be used for one type of operation. And if a bank wanted to find a customer's balance on a certain date, it had to run the file of all customers' accounts, because the early computer was a sequential, plodding device, somewhat like the old drill press. With today's information technology, the drill press can produce whatever product the user wants. And with programmable software and the "random access" memory, the computer can be made to retrieve and do what its owner wants—and more. This combination of technologies creates a kind of hydraulics of the mind that is truly revolutionary.

The information revolution, moreover, differs fundamentally from the other technological revolutions that have preceded it. One big difference is that, unlike the situation in the railroad and automobile industries, great sums of capital are not required to start up a successful venture in the information business. The entrepreneurs who put together the chips and write the software know that access to knowledge is more important than money. An individual sitting before his personal computer anywhere in the world can command in microseconds vast amounts of information stored in the data bases of the world. Information is becoming the new capital. While some argue that it is simply another commodity, it is really very different from any commodity we have ever seen before. Unlike commodities, information is not used up, though it can go stale and thus may lose its value.

For all these reasons, the information revolution is having a profound impact in many diverse areas. The ancient and basic concept of sovereignty, which has been discussed since the time of Plato, is being eroded by the new technology. Geostationary satellites launched and owned by one country have the capacity to transmit data to other countries. Copyright laws based on Gutenberg's movable type have been overtaken by a technology that allows printers at 100 different locations to spew out identical texts in seconds. The global marketplace has, in addition, fundamentally changed the nature and stability of monopolies.

At the moment, the United States can probably marshal more computer power, more telecommunications skills, more data banks, and more venture capitalists producing new software than any other country in the world. How long we can maintain this position no one

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knows. Even the most powerful cartels decay over time, as OPEC is now learning. If we were ever in a position to be a kind of OPEC of information, that time has passed. Our position is eroding at the very moment when the free flow of data is now almost as important to world commerce as the free flow of goods.

International Reaction

While science has been moving the world closer together, the politicians have been busy trying to keep it apart. Many foreign governments fear the effect of electronic information flows on their ability to control the flow of news to their own citizens; some fear the perceived threat to their citizens' personal privacy; some understand that the new technology makes possible the very rapid shift of resources out of their national jurisdiction; some fear the loss of their technology base; some see a threat to their own telecommunications industry or to the monopoly position of their government-owned telegraph and telephone system. Underlying it all, governments wonder if the new information age will shrink their tax base.

As more and more countries come to understand the importance of telecommunications linked to computers, governments are beginning to treat information as they once treated goods. We are seeing the growth of a kind of electronic mercantilism as sovereigns move to protect their power. Many governments are nervous if they cannot read our electronic mail. Some now require that the codes used by private communicators to preserve data privacy be registered with government agencies. It is the same principle governments used to invoke to justify steaming open envelopes, and creates the same policy dilemma.

More often than not, governments all over the world are reacting to the information revolution in the classic manner, by attempting to regulate, tax, and control the new technology. But this is not as easy as it seems. The use of satellites has now made a mockery of national censorship. No customs agent can stop a stream of electrons coming into his country from some 22,000 miles in space. Once people learn about alternatives, there cannot be politics as usual. History teaches that change occurs when people learn there is an alternative to what they believed was their lot in life. A minor but illustrative example of this occurred in Denmark. After allowing the broadcast of a few episodes of the TV program *Dallas,* the government canceled the show. A public outcry forced reinstatement of the broadcast. It is an unhappy fact that the number of governments in the world that encourage the free flow of news and data of all kinds is a small minority.

At the same time, it is becoming increasingly common for critical software and other intellectual property to be stolen from this country by people overseas and then resold back to us. The pharmaceutical industry is a case in point. When the Pfizer company introduced a new anti-arthritic drug (Feldene) in Argentina a few years ago, five Argentine companies already had generic copies of Feldene on the market. This kind of story has been repeated hundreds of times, in many parts of the world. The desire of the less developed countries and Eastern bloc nations to be on the receiving end of technology transfer is as natural as their wish to import vital machine parts. And *we* are inadvertently helping them. The Freedom of Information Act, designed to help citizens find out about the operations of government, is now being used to discover our latest technology and transfer it abroad without compensation.

Domestic Reaction

In 1980, after seven years of study and the expenditure of excessive amounts of taxpayers' money, the Federal Communications Commission gave up trying to determine where computing stops and telecommunications starts—gave up, that is, rules barring AT&T from entering the computer business. The effect of the bureaucratic delay on AT&T and IBM—and therefore on America's competitive position in the world—was immense. At a time when other countries were rapidly integrating computers and communications, there did not appear to be any central recognition within our government of the strategic importance of information technology. Meanwhile we all watched as a federal judge, doubtless doing his best, oversaw the breakup of the finest telephone system in the world and designed a new one in his courtroom, with no apparent concern for

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America's defense capability or our position in the world. Perhaps we still labor under the illusion that we really do not live in a global marketplace—that technology stays within political borders.

Yet, as the world marketplace has moved from slogan to reality, an awareness has been growing in this country about how heavily the world relies on the free flow of data across national borders. This reality is not yet fully appreciated, but its recognition must and will become central in the formation of policy on this matter. The flow of data affects the safety of the planes we fly in, the words we read, the TV programs we watch, the missiles that defend us, and the conduct and control of business, both public and private. All of this in turn affects the way we structure our society and creates a pressing need for the United States to put together and implement a policy on domestic and international information flow. We have not yet done so.

- What is, or should be, our policy on foreign taxation of transborder data flows? What should our response be when a foreign country asks U.S. multinational companies to register their computer codes with a government agency —or when a government-owned telephone and telegraph company charges U.S. companies more for telephone lines than it charges its own nationals, or even denies companies lines that are vital for the conduct of business? Congress recognized the importance of questions such as these in 1984 when it extended section 301 of the Trade Act of 1974 to cover the proliferation of non-tariff barriers to trade in services, including "restrictions on the use of data processing facilities" and "direct or indirect restrictions on the transfer of information." This new law is a step toward giving services equal standing with other vital exports. It authorizes the President to respond to protectionism in the services area as well as in goods. It also authorizes the President to promote bilateral and multilateral trade negotiations to remove foreign barriers to U.S. service exports, including requirements that data be processed locally and other barriers to international information flows. Since much of the world's development depends on keeping these circuits open, we must give still more priority to implementing an American policy that encourages the free flow of international information.

U.S. regulators at last November's meeting of the General Agreement on Tariffs and Trade understood this need. At that meeting GATT—created in 1948 to bring about contractually binding multilateral reductions in trade barriers—agreed to study whether communications services can come within its framework. This decision is a giant step toward defining and then resolving the emerging issues of the information age.

- What is, or should be, our policy when foreign governments permit their nationals to steal our research, or our policy on keeping national secrets secret? The lead we enjoy in information technology was created by men and women from Silicon Valley on one coast to Route 128 on the other. Our advantage rests on our unstructured society that encourages innovation. More than half of America's net employment growth in the five years ending in 1981 came from firms with twenty or fewer employees. But these firms are producing new technology faster than our government has produced new policies to protect it. Since American competitiveness will depend more and more on advanced technology, restoring the effectiveness of our patents and copyrights is a new and urgent policy challenge.
- Finally, what should our policy be on allocating slots in the geostationary arc? Should we support demands from some developing nations for access to that arc? Or should we hold to the position that the arc belongs to those who use it—the countries that have actually launched the satellites?

BECAUSE INFORMATION TECHNOLOGY cuts across all sectors of our society and affects both our domestic and foreign policies, it is not surprising that there is no particular part of our government that is in charge of formulating policy to answer these questions. Policy is currently split among the Department of State, the U.S. Trade Representative, the Department of Commerce, the Federal Communications Commission, and several other agencies. We have a number of ad hoc groups attempting to reconcile turf problems, but that may not be enough. The hour grows late. Providing a focus for our government's international information policy is, I suggest, a national issue that deserves our best thinking and best efforts. ■

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HELIUM— HOW MUCH IS ENOUGH?

Richard L. Stroup and Jane S. Shaw

THIS SEPTEMBER the secretary of the interior is supposed to write a check to the Treasury Department for about $790 million. That is the principal and interest now due on loans the department took out years ago to establish a conservation program for helium. Unfortunately, the secretary will not be able to write that check. Instead of paying for itself as originally planned, the program has gone more deeply in debt. And the Interior Department finds itself with an underground storage reservoir containing enough helium to supply the government's needs, at current rates of use, for the next 140 years.

By usual standards, helium is a nonrenewable resource. In the late 1950s many influential people worried that it would disappear, that the country would "run out." Congress responded with the Helium Act of 1960, creating a government program to extract and store the gas. Both when the program was initiated and while it was deteriorating, a number of questions were ignored: Was the Interior Department's Bureau of Mines relying on dubious forecasts of helium supply and demand to justify government intervention? Would the private market really have depleted helium supplies if the government had not intervened? More broadly, was the money being invested in the helium program well spent? Twenty-five years later, it is long since time to address those questions.

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Inflating the Regulatory Balloon

Helium is a gas whose distinct physical properties give it many space-age uses. Because it is inert, for example, helium can be used to purge rocket engines of contaminants. Because it has a low melting point—it freezes only under pressure—it can be used to cool materials to superconducting temperatures and to test spacecraft and hardware under extremely cold conditions. Because it is lighter than air, it is useful for lifting balloons and blimps.

As government space and defense programs burgeoned in the 1950s, government scientists were sure that the need for helium's special

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characteristics would grow. And some experts thought the gas had few if any substitutes. A 1959 Bureau of Mines study forecast that U.S. demand for helium—which was then running at about 360 million cubic feet a year—would exceed 1 billion cubic feet a year by 1967 and reach nearly 2 billion by the year 2000. Cumulative demand would total 65.8 billion cubic feet by the year 2000. Actually, demand did not hit 1 billion till 1978.

The lavish demand forecasts were accompanied by anxiety-provoking estimates of supply. At the time, natural gas wells were the only economic source of helium, and there were few natural gas streams that contained enough helium—a concentration of at least 0.3 percent—to make extraction economically viable. Indeed, in 1960, it appeared to the Interior Department that the only natural gas in the world with economically recoverable helium was in the Hugoton-Panhandle field, located where Texas, Oklahoma, and Kansas meet. The U.S. government, with five plants extracting helium from Hugoton-Panhandle gas, was at that time the world's only supplier. (Late in the 1930s it had bought and dismantled what appears to have been its only competitor.)

The lavish forecasts of helium demand were accompanied by anxiety-provoking estimates of supply.

As demand increased during the 1950s, shortages of helium were already beginning to appear, and projections indicated that the Panhandle field would run out of natural gas by the 1990s. The use-it-or-lose-it dynamics of helium at the well-head lent a special sense of urgency to the perceived supply-demand imbalance. If helium is not extracted from natural gas as it is produced, it is lost into the atmosphere. At congressional hearings in 1960, mining experts stressed that nearly 4 billion cubic feet were being lost each year—about ten times what was being consumed. A valuable, nonrenewable resource was apparently being wasted. Also at the hearings, several large natural gas producers—the ones likely to benefit from government contracts for helium—pushed for the proposed conservation program, saying that they were waiting only for a go-ahead from government. The U.S. Chamber of Commerce gave its support as well. And the regulatory balloon took off.

Coming Back to Earth

But not without a little help from the taxpayers. Although the program was ultimately expected to pay for itself, the 1960 act authorized the Bureau of Mines to borrow up to $47.5 million a year to finance helium purchases under long-term supply contracts with suppliers. With twenty-two-year sales contracts in hand, four companies—Cities Service Helex, Inc., National Helium Corp., Northern Helex, Inc., and Phillips Petroleum Co.—built helium extraction facilities at the Hugoton-Panhandle field; and the Bureau of Mines built a pipeline to carry its helium purchases to an underground reservoir at Cliffside, near Amarillo, Texas.

The bureau paid the contractors $11 per 1,000 cubic feet for the helium. To cover its full costs for the gas, storage facilities, and interest on the Treasury loans, it set a resale price of $35 per 1,000 cubic feet—more than twice the $15.50 that federal agencies had previously been paying and 80 percent more than the $19.50 that commercial users had been paying. Government officials apparently did not think that a higher price would have an effect on supply or demand.

For a few years, the department did indeed succeed in selling helium at $35 to both federal and private users. But the $35 price was high enough to attract competition from strictly private extraction plants. By 1969, seven new suppliers had sprung up to serve private users, and they had not only dropped their helium price to $20–23 per 1,000 cubic feet but had captured over 45 percent of the total market. (These private suppliers had another advantage in addition to price: they could also supply helium in liquid form, while the government could not—it had no liquefier.) Yet the government refused to change its price, and the Bureau of Mines lost all its customers except for the federal agencies, which were required by law to buy from it. The secretary of the interior went to court (unsuccessfully) to force federal agencies to require their contractors to buy government helium.

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Then some of the captive federal users began to cut back. The Weather Bureau and the Atomic Energy Commission found $35 helium not quite as vital to them as $20 helium and turned to alternatives such as hydrogen and argon. Federal demand shrank for other reasons, too. The Defense Department shifted from Atlas missiles, which had used helium to pressurize fuels, to Minutemen, which did not. In 1969, Hollis M. Dole, assistant interior secretary for mineral resources, told the House Subcommittee on Mines and Mining that when the conservation program was authorized, "there was a strong feeling that helium was unique in all its applications, instead of being unique only in some, such as reaching the lowest ranges of temperature. There was also the feeling that price was not too important a factor in its use." As early as 1969, these assumptions had been proven wrong.

The Weather Bureau and the Atomic Energy Commission found $35 helium not quite as vital to them as $20 helium, and turned to alternatives such as hydrogen and argon.

But the space program still kept alive hopes for strong helium demand. A Bureau of Mines study presented at the 1969 House hearings forecasted that federal use would top 1 billion cubic feet by 1976 and reach a cumulative total of 47 billion between 1970 and 2000—a less bullish forecast than the 1959 study's, but bullish nonetheless. The bulk of this demand—42 billion cubic feet—was to come from the National Aeronautics and Space Administration. Two years later, when NASA's programs were being axed right and left, a more accurate study by the bureau cut the estimate of cumulative federal demand by 85 percent, from 47 billion cubic feet to 7 billion, with annual usage topping out at 272 million cubic feet. Actual federal usage in the 1980s has in fact been running at about 265 million cubic feet a year—compared with 277 million in 1959.

Even as federal demand for helium slumped, supply was turning out to be unexpectedly abundant. In 1961 a new, helium-rich natural gas field was discovered in southwestern Wyoming—the Riley Ridge or "Tip Top" field. Its potential proved to be extremely large. Today, the federally owned part of the field is estimated to contain between 93 and 200 billion cubic feet of helium—that is, at least two-and-a-half times and perhaps as much as five or six times the current federal stock of crude helium. At present rates of federal use, the Riley Ridge field could supply the government's needs for at least 372 years and perhaps as many as 800 years. An additional factor boosting helium supply was the development of technology making it economically feasible to extract leaner streams of helium from natural gas.

To be sure, it took a while for officialdom to change its policies. Three companies that had built plants on the basis of the twenty-two-year government contracts argued in 1969 before a House subcommittee that the program was still needed. And even so eminent an economist as Alan Greenspan, a consultant to these companies, claimed that by 2010, the price of helium would be $140 per million cubic feet, so the program would ultimately pay for itself and should be continued. But Congressman Wayne Aspinall, chairman of the House Committee on Interior and Insular Affairs, labeled the program "a weight around our necks"; the taxpayers, he said, "just cannot be expected to pay for this kind of conservation." In 1973, after buying 32.2 billion cubic feet and storing most of it, the Bureau of Mines canceled its contracts with helium producers. (A number of them quickly filed breach-of-contract suits, setting off years of litigation, only recently settled.) Thus the main activity of the program now is to store helium supplies, which currently amount to 35 billion cubic feet.

In 1973, after buying 32.2 billion cubic feet of helium and storing most of it, the Bureau of Mines canceled its contracts with helium producers.

One might think that the question today would be not whether to conserve helium but how the government should get rid of its stocks. But no. Edward Hammel, Milton Krupka, and K. D. Williamson, Jr., writing in *Science* magazine in February 1984, point out that new exotic

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helium-using technologies continue to crop up. Even though the need to develop technologies such as fusion energy has decreased with the price of oil, the "eventual need" for those technologies and "the large amounts of helium they require" have not disappeared. Moreover, for many technologies, "helium is a sine qua non." These scientists warn that when Riley Ridge is exhausted, someday, the only source of helium might be the atmosphere itself, where helium exists in huge quantities but minuscule concentrations. And they estimate that extraction from the air would cost $10,000 to $20,000 per thousand cubic feet of helium, compared with $10 to $20 under current methods. But, they argue, it is "unlikely that private industry could be persuaded to conserve any of the Riley Ridge helium for future sales, primarily because the costs of so doing could not be recovered in less than 10 to 20 years." Thus, if helium is to be conserved, "it will have to be done by the federal government."

Regulation vs. a Market Scenario

The string of unanticipated outcomes of the government's helium program offers reason to be cautious about enlarging the government's role in helium conservation—or even about continuing it at the present level. The obvious, visible cost of the 1960 Helium Act is the $790 million that Interior is supposed to repay to Treasury and plainly cannot. But the larger cost is a less apparent one. Too much conservation can be every bit as bad as too little. Using scarce resources—engineering talent, steel, construction crews, and so forth—to extract, transport, and store helium, for example, diverts those resources from other, possibly more valuable uses. Economists call this trade-off the "opportunity cost" of investments. The helium conservation advocates have consistently failed to acknowledge the "opportunity cost" of investing in helium.

The helium conservation advocates have consistently failed to acknowledge the "opportunity cost" of investing in helium.

Suppose you expect $100 of today's helium to be worth $500 fifty years hence. Invested elsewhere at, say, 10 percent a year, the same $100 will yield $500 in a mere sixteen years and $11,700 in fifty years—clearly a much better payoff and therefore one that your heirs should applaud. Only when the real (inflation-adjusted) price of a good rises faster than the real rate of interest (which measures the productivity of investments put to other uses) will it make sense to hold a resource. Dennis Epple and Lester B. Lave note in a 1982 article in *American Scientist* that, based on historical experience, it is far more likely that the return on other investments will exceed the return on investment in helium. Declining real prices have "been observed over the last half century for almost all depletable resources. . . ." This suggests that faster use of the resources would have served society better. However, they fear that "the tangle of legislation resulting from government storage of helium" will make producers afraid to store helium privately. So they suggest modest government storage and no further venting of the richest helium streams.

But *who* holds the resource also matters—a fact that Epple and Lave fail to note. To analyze opportunity cost, the holder of helium must forecast future price, and most price forecasts —as helium has vividly demonstrated—prove wrong. A government program, based on a single bureaucratic forecast, is far more likely to be wrong than right. Moreover, a government plan is far more difficult to change, once error is recognized, than a private plan. The glut of government helium was apparent by the late 1960s but helium purchases were not halted until 1973. All investors hate to send good money after bad, but the aversion is far stronger when the money is the investor's own, not the taxpayers'. Private investors simply have more incentive to ask painful questions, swallow their pride quickly, and correct their errors as information changes.

What would have happened without a government conservation program for helium? The immediate demands of the government for helium would have been met by entrepreneurs using private investment funds. At least one potential helium producer, Eastern Petroleum Co., would have done so in 1959, according to congressional testimony, had the government not set up a monopoly. Thereafter, private in-

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vestors would have positioned themselves for profit by building extraction plants or negotiating for extraction facilities at gas production plants, as the investors judged that demand from federal or private consumers was likely to increase. Alternatively, larger consumers like the Defense Department and NASA could have contracted for helium development in stages, as DOD does with a new bomber, or could have operated extraction facilities tailored to their own needs.

Longer-term needs would have been protected by the greed of speculators. Speculators, after all, are like distributors, except that they transfer the goods along the dimension of time, not geographical distance.

Longer-term needs would have been protected by the greed of speculators. Speculators, after all, are like distributors, except that they transfer the goods along the dimension of time, not geographical distance. Wholesale distributors buy oranges in Florida, where they are cheap and plentiful, and sell them in Montana, where they are scarce and more expensive. Speculators buy resources now, when they are cheap and plentiful, and hold them for sale in the future, when they are expected to be scarcer and to command a higher price.

During the early years of the helium program, bold investors were funding such expensive, risky, and speculative ventures as Outer Continental Shelf oil and gas exploration, wildcat oilwells, and speculative office buildings. *Credible* forecasts of large demand and dwindling supply of helium would certainly have spurred private investment in helium, too. Even forecasts *not* credible to most people (such as that by the Bureau of Mines) might also have spurred investment, but then private speculators—not the taxpayer—would have paid the price.

And a final irony of the government "conservation" proposal is worth noting. One of the greatest pressures for venting helium at Riley Ridge is that the gas wells there are located on federal land, and companies that hold

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federal gas leases are not allowed to lease the rights to the associated helium. The 1960 Helium Act kept those rights in federal hands. Thus, if the Bureau of Mines does not take the helium or sell the rights to it, the producers are obliged to vent it as a waste gas, since they cannot sell it. The leasing regulations, in other words, ensure there will be a "problem" for the government to step in and solve.

Looking Ahead

History suggests that most fears of running out of nonrenewable resources are vastly exaggerated. Dire forecasts of the depletion of valuable raw materials have always been proven wrong. When a valued material becomes scarce, its price rises, cutting demand and spurring entrepreneurs to search for new supplies and substitutes. In the nineteenth century, for example, whale oil became scarce and petroleum quickly filled the gap. As Julian Simon reminds us in *The Ultimate Resource*, the noted economist W. Stanley Jevons predicted in 1865 that England could not continue its "present rate of progress" because the nation would run out of coal. Yet coal is more plentiful than ever today.

Often resource forecasts that are ultimately wrong gain temporary credence because of precipitous short-term rises in price, as in the case of oil in 1973 and again in 1979. Yet the price increases that cause the concern are themselves the means of bringing the situation more or less back to normal. Today in the United States, in spite of the dramatic increase in oil prices, the price of gasoline is only 21 percent higher, in real terms, than it was thirty years ago. During this period, real per capita disposable income went up over 90 percent.

There are many other examples of prophecies of scarcity going awry, and in all likelihood helium will continue to be one of them—provided its future is left in private hands. If scarcity is anticipated, the price will rise, which will stimulate the creation of substitutes and exploration for new supplies. Even the authors of the *Science* article acknowledge that there are alternative, though more expensive, supplies of helium, including low concentrations of helium in other natural gas fields, air separation plants now producing other gases, and liquid natural gas. While these sources are not economical today, they could be tapped long before we would have to build plants to draw helium out of the air at $10,000 to $20,000 per thousand cubic feet.

And then again, we may never see the extraordinary increases in demand that some people anticipate. Some way may be found to develop fusion energy and superconducting power transmission lines without helium. Or those technologies might never be developed at all. History is littered with promising technologies that flopped. Lighter-than-air dirigibles, for example—which got the federal government into the helium business in the first place.

At this stage, the government should do what even the Hunt brothers would do after being burned to the extent of hundreds of millions in the commodities market. It should cut its losses. That means renting or selling outright the storage facility and selling off the helium, retaining at most a quantity sufficient for emergency use.

Helium still in the natural gas at Riley Ridge deserves no less. The law should be changed to permit the government to lease the helium along with the gas. Natural gas firms could then strike their own deals with private helium suppliers and speculators. Better still, speculators, not just natural gas firms, should be allowed to buy and hold natural gas (and the associated helium) if they so desire. At present, companies that lease rights to federally held natural gas are required to develop it within a certain amount of time. This seems a trifle ironic. It means that the government is requiring producers to bring helium to the surface sooner than they would wish, so that the government can pump it back into the ground and store it, both at great expense. Why not allow helium to be stored henceforth at private expense in nature's own reservoirs? Both Adam Smith and the Sierra Club should approve. ■

Selected Readings

Dennis Epple and Lester B. Lave, "The Helium Storage Controversy: Modeling Natural Resource Supply," *American Scientist*, May/June 1982.

Edward F. Hammel, Milton C. Krupka, and K. D. Williamson, Jr., "The Continuing U.S. Helium Saga," *Science*, February 24, 1984.

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Telephones and Computers

William J. Baumol and Robert D. Willig

THE TECHNOLOGIES of computers and telecommunications have fused. Computers call each other over telephone channels to exchange information and coordinate their operations. Telephones have evolved into miniature computers, and telephone switchboards into bigger, more powerful ones. The telephone network is itself a giant computer, with its intelligence spread throughout its length and breadth instead of concentrated at one site.

Although the marketplace eagerly accepts this fusion of technologies, the Federal Communications Commission (FCC) has been standing athwart the tide of history crying "halt." The FCC's rules require the nation's largest phone company, AT&T, to keep its telecommunications operations entirely separate from its computer business. Thus, whenever AT&T offers telecommunications services that are "enhanced" to include a variety of data processing services, it must supply the latter through a separate part of the company, out of a separate location, and using a separate computer, instead of through the same computers and locations that comprise its telecommunications network.

The "separation" rules are responsible for a host of other inefficiencies as well. For example, many large Japanese companies maintain internal libraries of the computer software their divisions produce, so that expensive programming need not be done twice. But the FCC rules hamper AT&T's efforts to do the same thing. AT&T's incomparable research arm, Bell Laboratories, invests millions every year to design software for the company's long-distance network—software that it is not allowed to share with the company's commercial computer activities.

The rules in question—issued in 1980, three years before the court-ordered breakup of AT&T—force the firm to separate its operations into two compartments. Under those rules, one compartment provides basic telecommunications services and is regulated; the other sup-

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plies computer and telecommunications equipment and computer-enhanced services and is not regulated. What this has meant for AT&T's own competitive position is clear enough. The rules put the company at a significant disadvantage in the exploding new market for customer services that integrate computers and telecommunications. But the consequences of the FCC's separation rules stretch further than simply the bottom line of AT&T alone. Because the rules impede the use of AT&T's valuable resources—including billions of dollars in plant and equipment, an illustrious research organization studded with Nobel awards, nationwide marketing forces, and long experience—U.S. technology as a whole may be the loser. That is why the FCC proposed in January of this year to eliminate a substantial portion of the 1980 separation rules, and why even that reform may not go far enough.

Because the rules impede the use of AT&T's valuable resources . . . U.S. technology as a whole may be the loser.

How the Separation Rules Came About

In the 1970s, computers and telecommunications were becoming ever more interdependent, and by the end of the decade the boundary between them had all but vanished. The technologies, as we have said, had fused. Computers had learned to "talk to each other" by telephone. And the telephone system had come to rely heavily on computer technology for switching, routing, storing, and other activities. A modern telecommunications switch no longer makes mechanical electric connections—it is instead a highly sophisticated computer. If a call from New York to San Francisco encounters a sudden surge of traffic that clogs the Chicago portion of the route, the call may automatically be rerouted via St. Louis by an intelligent switch. Computers also permit sophisticated and valuable new services such as call forwarding, call recording and data storage, on-line translation between computer languages, and automatic conferencing.

As this convergence proceeded, companies like IBM acquired immense expertise in telephone matters, while companies like AT&T acquired immense expertise in computer matters. The inevitable result was that both kinds of companies found themselves with valuable services and products which they were forbidden by regulation to sell to customers. In the 1970s, one of these two barriers fell: competitors won the right to enter AT&T's market for long-distance telecommunications. At about the same time, the FCC began to inquire whether AT&T should be allowed, in turn, to enter the computer field. The FCC reasoned that this convergence could not be held off forever; nor was it defensible to allow others to come onto AT&T's turf but not vice versa. But, at the same time, the commission feared that freedom for AT&T to enter computer-related markets, unless accompanied by safeguarding regulations, would enable the company to exercise and extend monopoly power.* After all, this was before the 1984 divestiture, so AT&T still owned its twenty-one local telephone companies, the Bell operating companies (BOCs). These companies, with their bottleneck facilities, possessed unique, monopoly access to household and business telephone customers. AT&T's competition, moreover, was still new and confined mostly to providing equipment and long-distance service for large businesses.

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In particular, the FCC feared that a new regime would invite "cross-subsidy." If the

*The FCC was also concerned that a freer arrangement might run afoul of the 1956 consent decree that had concluded an earlier Department of Justice antitrust case. That decree largely prohibited AT&T from engaging in businesses other than telecommunications.

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THE STRUCTURE OF AT&T

Now (and before 1984)

COMMUNICATIONS SECTOR

AT&T Communications supplies domestic and international long-distance communications services. It is permitted to sell only "basic" services, which are regulated. (Before divestiture, this sector was called AT&T Long Lines, and provided all international and most interstate long-distance communications services. The twenty-one Bell Operating Companies, now divested, provided all intrastate and the rest of the interstate long-distance services.)

TECHNOLOGIES SECTOR

AT&T Bell Laboratories is the R&D arm of AT&T. (Formerly it was Bell Telephone Laboratories, a subsidiary of AT&T.)

AT&T Technologies produces electronic equipment, components, and software. (Formerly it was Western Electric Co., a subsidiary of AT&T.)

AT&T Information Systems markets electronic equipment and "enhanced" and other unregulated services to businesses and consumers, and does some development and software design. (Its predecessor, American Bell, was created in response to Computer II [see text]; before then AT&T was not allowed in such unregulated businesses.)

AT&T International markets AT&T products and services abroad. (Its status was unaffected by divestiture.)

Note: The FCC regulates AT&T in two different ways. First, it regulates the prices and characteristics of the interstate and international services of AT&T Communications under the direct authority of the Communications Act of 1934. Second, since 1980 (Computer II), it has maintained restrictions that separate the activities of AT&T Information Systems from those of Bell Labs, AT&T Technologies, and AT&T Communications.

activities of the different parts of AT&T were intermixed and certain kinds of direct transactions among the parts were permitted, the earnings from the basic, regulated telephone monopoly might provide a hidden source of funds that the company could channel to its unregulated enterprises operating in the competitive market for new services. If the regulated part of AT&T were to sell services to the unregulated parts at prices below the pertinent costs, or if costs were assigned without economic justification to the regulated services, then the latter would appear to receive lower earnings. Federal and state regulations might then permit basic transmission rates to rise, thereby allowing the regulated services to recoup the profits passed along as a cross-subsidy to the unregulated entity. As a result, the entire firm could enjoy higher earnings. Or it would be able to compete unfairly in its competitive markets, using the cross-subsidy to finance uneconomically low prices for its products, in the hope of higher future earnings.

Equally important to the FCC was concern about what the Bell operating companies themselves might do—concern that they might be inclined to deny to AT&T's competitors the access to local networks that is essential to many new computer-based services and products. It was feared that, in the highly complex world of electronic interfaces, there might be temptingly subtle ways by which one of AT&T's local phone companies could make life easier for its parent and harder for its parent's rivals.

To prevent these problems, the FCC's Second Computer Inquiry decision (Computer II, 1980) imposed a series of restrictions on the new subsidiary AT&T was creating to supply computerized and other unregulated products and services to the public. That firm, American Bell, became AT&T Information Systems (AT&T-IS, see box) at the time of the 1984 di-

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vestiture. Under the separation rules, AT&T-IS is required:

- To keep its accounts and records completely separate from those of the rest of AT&T;
- To share no facilities and practically no staff with other parts of the company, even in marketing;
- To sell no basic services (telecommunications transmission), even if consumers are eager to buy those services "bundled" with their purchases of customer premises equipment (telephones, switchboards, answering devices, and so on);**
- To acquire no software from AT&T Technologies (formerly Western Electric) or Bell Laboratories unless the software is simultaneously made available on the same terms to outside buyers, even if those buyers are AT&T's direct competitors and hope to imitate its products.

Corresponding restraints were placed on the rest of AT&T. For example, AT&T Communications Inc., the regulated long-distance carrier of basic transmission services (formerly AT&T Long Lines) is prohibited from supplying "enhanced" (that is, computerized) telecommunications services to itself and to the outside market. It also cannot sell consumer premises equipment (CPE), which must be distinguished from AT&T telephone network equipment by an arbitrary boundary.

These rules were not imposed on rival long-distance carriers, such as MCI and GTE Sprint, or on competing foreign and domestic suppliers of telecommunications equipment to U.S. markets, among them Rolm Corporation, Mitel, ITT, Northern Telecom, and NEC. It is true that AT&T is a huge firm, but it is also true that some very powerful firms—both bigger and smaller than AT&T—are legally allowed to bridge the computer/telephone gap. Earlier this year, for instance, IBM took over Rolm, a Silicon Valley firm that is America's second largest seller of PBX's (private office "switchboards"—today computerized and "smart"). IBM is also a major owner of Satellite Business Systems, which sells long-distance data and voice telecommunications services. The giant firm is expected to combine these operations in order to develop and market integrated systems that make possible coordinated and interactive data processing and communications over a network of locations. A host of other major international corporations are pursuing a similar strategy, including Wang and NCR Corporation at home, and Japanese and British firms undergoing denationalization and deregulation.

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The FCC's Proposed Reform

In April 1984 AT&T asked the FCC to drop the Computer II restrictions, and nine months later, in January 1985, the commission replied with a proposal that went part of the way. In particular, it proposed to "remove the structural separations conditions from AT&T's provision of CPE," to waive the rules so as to allow AT&T-IS to make "unrestricted use of proprietary software on a fully compensatory basis," and to permit AT&T Technologies to provide personnel as well as recruiting services to AT&T-IS.

Unfortunately, the new proposals leave on the books the FCC's crucial restrictions on enhanced services.

If these proposals survive the public comment period, they will lessen some of the worst inefficiencies caused by the Computer II rules. Unfortunately, however, they leave on the books the FCC's crucial restrictions on enhanced services. That is, the FCC will continue to prohibit the different AT&T subsidiaries from jointly developing, producing, and marketing services and products that lie on different sides of the arbitrary boundary between basic (regulated) and enhanced (unregulated) telecommunica-

**In 1984 the FCC decided to allow AT&T-IS to *resell* widely used, tariffed services of AT&T Communications, but to continue to prevent it from owning facilities for providing basic services.

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tions. Moreover, it appears that the FCC intends to continue to subject AT&T to information disclosure requirements that do not apply to its domestic and foreign competitors.

Thus, the regulatory separation of computers and telecommunications remains a pressing issue today. It requires careful description and analysis, and these are the tasks to which we now turn.

Revolution in the Telephone Industry

While there may have been some logic to the FCC's separation rules in 1980, the subsequent upheaval in the industry has rendered them obsolete, removing the promised benefits of the restrictions and multiplying the social costs. Three of these developments are worth special attention: the explosive growth of competition, the divestiture by AT&T of its local operating companies, and technological changes that have destroyed the boundaries between basic service and enhanced service and between telecommunications equipment and computer products. But before dealing with these developments individually, let us comment on their general relevance.

Recall that the chief danger of allowing a firm to operate in both the regulated and unregulated sphere is that of "cross-subsidy": either the regulated part of the firm will underprice the products it sells to its unregulated affiliate, or the parent firm will overassign joint costs to the regulated entity. In either case, the regulated entity may be able to recoup its earnings "loss" (that is, the loss that appears in its own books) via the regulatory process, while the unregulated entity comes out ahead. Neither of these strategies can work, however, when the regulated entity faces substantial competition and thus does not possess significant monopoly power.

Suppose the regulated entity tries the strategy of underpricing the products that it sells to its unregulated affiliate. If there are competing suppliers of the products in question, the market will provide clearly visible benchmark prices that regulators can use to check the legitimacy of transfer prices. Furthermore, if the regulated entity sells the same items to all others who want them, its underpricing will provide a subsidy to rivals as well as to friends. Finally, if the other services that the regulated entity provides are subject to competition, it may be unable to raise the prices of those services as an offset—which would make the whole venture of underpricing a pure drain on profits. Nor will the other strategy, misassignment of common costs, be effective in an environment in which competition puts an effective ceiling on prices. Even if the regulators did allow the regulated entity to raise its rates to cover the fictitious costs, the effect would just be to drive its customers into the arms of its competitors. (This is the very reason why the prices of most of the services offered by AT&T Communications no longer need to be regulated. Any attempt to raise prices significantly above costs would prove to be unprofitable because of the resulting loss of business to the rivals of AT&T Communications. See Michael Katz and Robert Willig, "The Case for Freeing AT&T," *Regulation*, July/August 1983.)

The Growth of Competition

Since the FCC's 1980 decision, competition has accelerated spectacularly throughout the industry—with the obvious exception of local exchange service. The market for traditional long-distance service, the only AT&T service whose prices and rate of return are still regulated directly, has seen an extraordinary rise in competition. Back in 1980 AT&T Long Lines invested nearly $1 billion in plant and equipment, while its rivals invested only about $0.3 billion. But by 1983 Long Lines had fallen behind, putting about $1.1 billion into investment compared to some $1.6 billion by its rivals. It is now widely projected that, by 1986, the total long-distance transmission capacity of the competitors will be several times larger than AT&T's (*Fortune*, January 7, 1985).

It is now widely projected that, by 1986, the total long-distance transmission capacity of the competitors will be several times larger than AT&T's. . . .

In equipment sales, the story is much the same. Many observers think that a Canadian

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firm, Northern Telecom, now sells the best small and medium-scale electronic switching machines, and that the Japanese may soon become the world's best suppliers of fiber optic transmission systems, in terms of both quality and price. The number of competing producers of microwave transmission systems is growing. AT&T's small share of telecommunications satellite capacity continues to shrink, and many new firms are actively innovating in earth station facilities for satellite transmission. In long-distance equipment, the market share held by AT&T Technologies has declined along with AT&T's share of investment. Even AT&T Technologies' sales of exchange switching equipment to the divested BOCs, sales that might have been expected to suffer hardly at all from the incursions of competitors, have fallen from the predominant share of the market in 1980 to less than half the market currently ("Central Office Equipment Markets," Northern Business Information Inc., March 1984). The enormous and continuing growth of competitors in number, size, and capability means that AT&T no longer possesses significant monopoly power in most of the long-distance and equipment markets. There is little reason to fear that in today's competitive environment either arm of AT&T can manipulate its prices to provide significant cross-subsidies to the other.

The Role of Divestiture

Aside from competition, the most dramatic development in the recent history of telecommunications has undoubtedly been the antitrust settlement that led to AT&T's January 1984 divestiture of its local operating companies. The implications of this action are profound.

First, at one chop, it cut AT&T off from its remaining genuine monopolies—the twenty-one local telephone companies. Second, because these companies are now independent, they no longer have any incentive to spend money or incur costs in ways intended to benefit AT&T. Indeed, the antitrust settlement explicitly enjoins them from giving AT&T preferential treatment, and they are watched very closely in this regard, both by the local regulatory agencies and by AT&T's competitors. Moreover, the BOCs are not only independent but are already very much acting as such. They are competing with their former parent in the provision of computer and telephone premises equipment and in the supply of some interexchange network services. A number of spirited contests between the BOCs and AT&T are underway in these markets.

Obviously, the fear that a regulated division of AT&T might find a way to cross-subsidize AT&T-IS cannot sensibly be extended to relationships between AT&T and the [now very independent] local telephone companies. . . .

These developments have largely eliminated the rationale for the FCC's 1980 Computer II decision. Obviously, the fear that a regulated division of AT&T might find a way to cross-subsidize AT&T-IS cannot sensibly be extended to relationships between AT&T and the local telephone companies. For the latter have no reason to sell anything to AT&T at an uneconomically low price.

The divestiture of the BOCs also guarantees that AT&T will not manipulate its equipment prices. It cannot overprice equipment because the BOCs, its main customers, can and do shop elsewhere. Nor can it afford to supply such equipment at prices that are too low and, hence, uncompensatory, since that would simply constitute a gift to the BOCs (and to other ouside buyers) in which AT&T no longer retains any financial interest. Since nearly 90 percent of AT&T's equipment production is now sold to outsiders who have access to many alternative sources of supply, AT&T is hardly in a position to misprice the equipment it sells to its own subsidiaries.

Drawing an Arbitrary Line

A major source of the social costs of FCC's separation decision is the practical difficulty of drawing a clean line between telecommunications and computers, between basic services and enhanced services. The distinction between these categories, not very clear even in 1980, is now so blurred and unrecognizable that the separation rules would be practically unworkable even if their purpose were still pertinent.

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Two illustrations will suffice to demonstrate the point.

The first is the case of "private networks" put together for a single organization. A private network carries voice and data between and among people and computers within a firm and to the outside world. These networks are run by "intelligent PBXs" whose central computers direct the internal distribution of messages. Because a private network can take advantage of scale economies in handling congestion, it reduces the number of phone lines needed. In addition, it can process and translate information flows between computers, interconnect with satellite and terrestrial long-distance facilities, and record and forward calls on command while it receives and answers them.

The second example is the development of the "smart building." The smart building offers the services of a private network to all the tenants of a single edifice or an industrial park (and also runs the heating plant and the elevators!). Because of the diverse demands of the various users of such a system, integration of basic and enhanced services is even more essential here than for the private network serving only one firm. Although these buildings may seem futuristic, several of them are already in existence, and surveys of real estate developers indicate that a good many more are under way.

Under the separation rules, AT&T is prevented from efficiently organizing its efforts to bring these innovative services to the marketplace. Private networks and smart buildings require careful matching of the customer's needs with the most advanced telecommunications and computer technology. But in many situations the separation rules prohibit AT&T from

... in many situations the FCC's separation rules prohibit AT&T from speaking directly to its customers.

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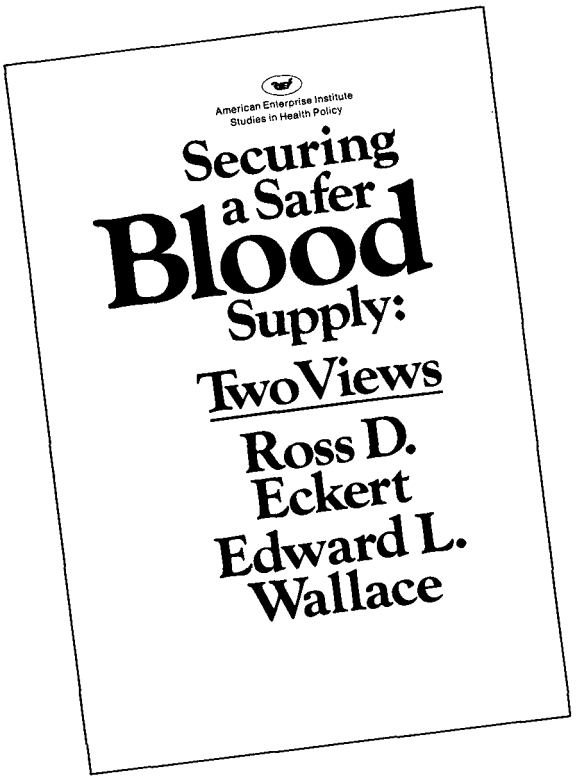

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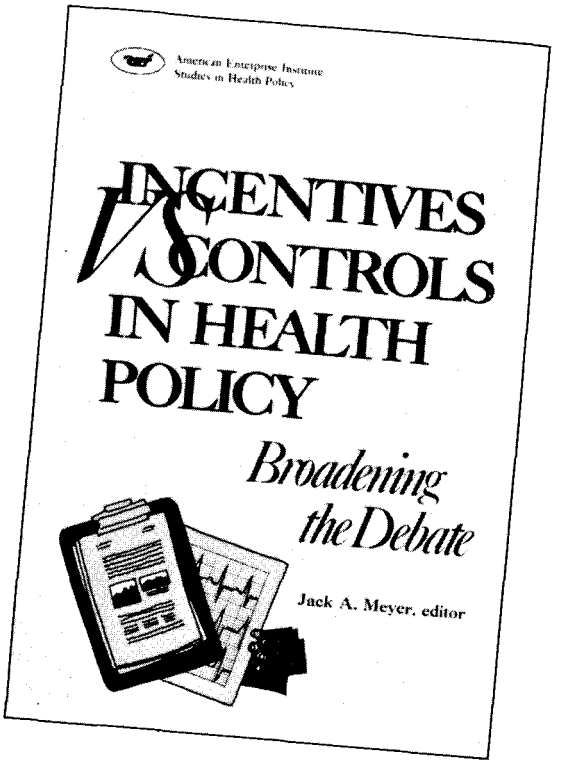
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speaking directly to its customers. For example, AT&T Technologies, the company's equipment manufacturer, may not sell directly to end-users, which means that it can offer its software to the user only by working through AT&T-IS or some non-AT&T distributor. But if it does work through AT&T-IS its proprietary software must be made generally available to outsiders, including AT&T's competitors, on an equal basis. Thus, the separation rules deprive AT&T of the full benefits of its own innovations, and dull the incentives to generate them. AT&T is the only firm in the industry that is hampered by such regulatory controls.

The artificial separation in this area gives rise to five principal social costs:

(1) *Unmet consumer needs.* Consumers want services tailored to their particular needs; and they neither notice nor care that some of the inputs they require are classified as "basic" and others are classified as "enhanced" or "CPE." The separation rules prevent AT&T from meeting its customers' demands for integrated services through the coordinated efforts of several subsidiaries. Thus the major competitor in the market is hobbled.

(2) *Costly duplication.* Some enhanced services offer substantial economies of scope and scale when sold in combination with basic services. The separation rules make necessary a duplication of capital, labor, and other facilities. Much money could be saved, for example, if AT&T could unify its sales forces and billing operations, particularly in marketing to customers who want to buy packages of basic and enhanced services and equipment. As we have already noted, much of the software developed by Bell Labs or AT&T Technologies would be used elsewhere in the firm were it not for the separation rules. In addition, without the rules AT&T would be able to use the same computers that are integral to its long-distance network to provide enhanced communications services as well.

(3) *Distorted incentives.* The separations boundaries also distort underlying profit incentives. The problem arises when an end product (or end service) requires the coordination of inputs from the different, separated parts of the company established by the FCC. Under the rules, AT&T Communications often will find it unattractive to invest in facilities for transmitting a new enhanced service whose market is still uncertain. For if the new product turns out to be a great success, the regulated subsidiary's profits are held to the fixed regulated rate, and if the product fails, the loss may be absorbed by the parent.

There are well-known efficiencies in allowing firms to coordinate the design, production, and marketing of services or products that are complementary. To illustrate, consider a superior new type of razor that is produced by two firms, one of which has developed the blade and the other the handle. If the two firms are forced to operate independently, each may try to raise the price of its own component in an attempt to capture for itself most of the razor's potential profits. And the result would be a total price too high to maximize *both* firms' profits (and to optimize both consumer welfare and the incentive to invent useful shaving products). Unregulated markets take care of this sort of distortion of incentives by integration (both vertical and among complementary lines of business), joint ventures, equity holdings among firms, or agreements for joint product development and marketing. But such arrangements are explicitly denied to AT&T by the FCC's separation rules.

(4) *Disincentives for R&D.* Research and development are particularly hard hit by the separation rules. The rules require that R&D projects be assigned to one side of the line or the other, but there is no way to predict whether a research success will yield a product on side A, or side B, or both. The more basic a research activity is, the less predictable and more broadly applicable its results are likely to be. Since it is difficult to obtain suitable compensation for new ideas from unaffiliated beneficiaries, the efficient use of R&D in electronics today requires the sharing of information among integrated entities. But once again, this is forbidden at AT&T.

(5) *Cost of uncertainty and litigation.* Regulatory restrictions also invite deliberate distortions of the marketplace, distortions that rival firms create to protect themselves from competition by the regulated firm. Where the rapidity of technological change ensures that the rules will be hazy, which is the case with the FCC's Computer II decision, there will always be something to litigate about. Litigation slows a firm's competitive response to market conditions and adds to the high risk burden that is

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already posed by most high-technology investments.

Conclusion

The FCC's 1980 decision was based on cost-benefit grounds. That was then, and continues to be, the right criterion. But the balance of costs and benefits has changed. What might have seemed a tenable boundary in 1980 has now become an arbitrary wall that prevents effective efforts to meet consumers' needs and the challenges of competition. The obsolescence of the line can only mount as the technologies involved become increasingly complex and convergent.

It is ironic that among the main beneficiaries of continuation of the FCC's rules are AT&T's integrated foreign competitors, which are not subject to similar restrictions and which market combined computer and communications services on a global scale. Our leading supplier of telecommunications services and products is bound up in a net of regulatory restrictions at the same time that its foreign rivals, far from being handicapped by their governments, receive from them systematic aid and encouragement. This is not meant as an argument for trade restrictions of any sort—only for the elimination of the senseless restraints that this country imposes on the conduct of its own, leading firm in the world telecommunications market. If the public is to gain the full benefit of the revolution in computer and telecommunications technology, an equally dramatic revolution will have to take place in the world of regulation. ■

It is ironic that among the main beneficiaries . . . of the FCC's rules are AT&T's integrated foreign competitors, which are not subject to similar restrictions and which market . . . on a global scale.

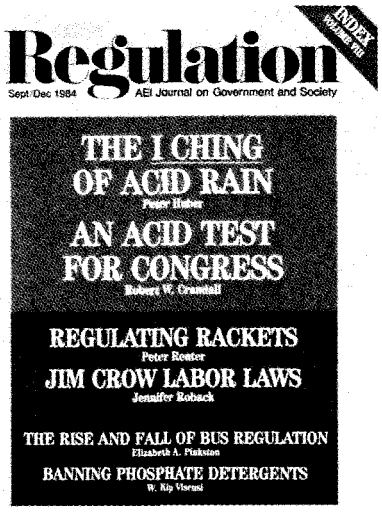
Letters to the Editor

(Continued from page 3)

The market for the Mirabel plant's output is uncertain. The plant is to produce light bi-turbo helicopters. The government stipulated in 1982 that Canada's defense forces would not be purchasing any of the 'copters, and light bi-turbos account for only 0.6 percent of the Canadian civilian helicopter market. Indeed, only six helicopters of *any* type were sold in Canada in 1984, and the total number of 'copters in circulation has actually declined by one (to 956) since 1980.

Bell Helicopters, however, assures the government that its production (to commence in January 1987) will be ten 'copters a month, presumably for export. But the export market seems equally uncertain, for several reasons. First, a 1982 study by the consulting firm Aviation Planning Services (recently leaked to the press) claims that, as far ahead as 1990, light bi-turbo 'copters will hold only 16 percent of the world market, and that their share is not growing. Second, the world supply of light bi-turbo 'copters is more than adequate now. Only about ten such helicopters (of any make) were sold in the world last year, according to Mr. Phillippe Orsetti, vice-president in charge of American operations for the French firm Aérospatiale.

Bell has made it exceptionally painless for potential buyers to place orders for these helicopters (a mere $10,000 deposit, interest-bearing *and refundable*, is all that it requires). Still, it would be interesting to know how many such "firm" orders it has in hand. It is a field where the French Aérospatiale seems to have the technological lead. Bell initially claimed that the Mirabel 'copters would have revolutionary new turbines, but it turns out that these are not available, so Bell will be going with the same motors used by all its competitors.



In its 1983 announcement, the federal cabinet proudly proclaimed that the plant would directly create 2,773 jobs. On March 4, 1985, Bell president Jim Schwalbe said the plant will employ 835 persons, *if* the ten-helicopter per month schedule can be maintained. This works out to a cost to taxpayers of $330,000 for each permanent job created (assuming they are permanent).

In part to calm the howls of Ontario residents after this plum was granted to Quebec, the federal government announced, also in 1983, that a similar (but smaller) and equally subsidized helicopter plant would be built by the German firm Messerschmitt - Bolkow - Blohm in Fort Erie, Ontario.

How will these firms sell more than 120 noninnovative 'copters per year? Will the federal government agree to buy dozens of unsold helicopters that taxpayers will already have paid for? Only time can tell whether the new Progressive Conservative government will decide to follow its predecessors up the well-worn path of "industrial policy."

Michael Krauss,
Université de Sherbrooke,
Quebec, Canada

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Statutes and Stopping Points

Building a Better Bubble at EPA

Michael H. Levin

In July 1981 General Electric discovered it could not install a new plastic-parts line at its Louisville, Kentucky, appliance plant in time to meet the state's October deadline for air emissions control. GE could shut the plant down and suffer large production losses, or risk noncompliance and substantial penalties, or buy a $1.5 million emissions incinerator that would be worthless when the old line was replaced. Instead, GE paid $60,000 to lease several hundred tons of emissions reductions that International Harvester had previously "deposited" in the Louisville "emissions bank," and used the reductions to satisfy state requirements on the old line a month ahead of schedule. The transaction saved GE about $1.5 million in capital and $300,000 in operating costs.

At about the same time, DuPont's Chambers Works in southern New Jersey faced state mandates for 85 percent reductions in emissions from each of 119 stacks, vents, and valves. Plant engineers proposed instead to reduce emissions at only 7 large stacks—but by over 99 percent. This proposal secured faster compliance and 2,300 tons a year more reductions than New Jersey had required. DuPont saved $12 million in capital and $3 million a year in operating costs.

These emissions trades and others like them were made possible by four incentive-based reforms that were first allowed, then actively encouraged, by the Environmental Protection Agency (EPA):

- the *bubble,* which lets emitters treat their *existing* sources of air pollution as if enclosed by a giant dome, trading reduced control on some stacks for extra, compensating reductions at others;
- *offsets,* which allow *new* plants or factory additions to begin operating in dirty air areas, if they secure more reductions from existing sources than the new source will add;
- *netting,* which exempts factory modernizations from burdensome preconstruction review, as long as other reductions ensure that "net" plant-wide emissions do not increase; and
- *emissions banking,* which gives firms legally protected credit for "surplus" reductions that can be stored for future use or sale.

These four developments—all variants of the "bubble concept"—have not been uncontroversial. Indeed, they have forced regulators, in-

Michael H. Levin heads the Regulatory Reform Staff at the Environmental Protection Agency. The views here are his own. *This article updates and substantially revises a paper that he and Milton Russell prepared for a May 1984 conference on comparative administration and law, sponsored by the Harvard Law School's Program on the Legal Profession and the Faculty of Laws at University College, London.*

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dustry, and environmental groups to confront both the benefits and the possible disadvantages of grafting incentive-based approaches onto the gnarled stock of the Clean Air Act. In that process, they have challenged—and, as recent events indicate, ultimately changed—some fundamental tenets of environmental regulation. A little background will help explain why.

Bubble Benefits

The Clean Air Act directs *EPA* to set nationwide *ambient* concentration standards for ozone (hydrocarbons) and other "criteria" pollutants, as well as uniform nationwide *technology-based* emissions limits for major new sources or modifications (the new source performance standards, NSPS), and still more stringent case-by-case emissions limits for processes subject to preconstruction new source review (NSR). The act also directs individual *states* to develop and enforce EPA-approved state implementation plans (SIPs) —states must inventory and control *existing* sources under an integrated scheme that will bring the state's air into compliance with the national ambient standards. State control of existing sources is thus the primary means for attaining healthy air; NSPS and NSR ensure that attainment will not be undermined as new plants add emissions.

This tiered approach accommodates both state pollution control efforts and Congress's desire to prevent the flight of new industry to lax "pollution havens." Over the act's first twelve years, it produced large reductions in total annual emissions of particulates and sulfur oxides (58 percent and 25 percent, respectively), despite substantial growth in coal-fired electricity and in America's industrial base (*EPA Journal*, September 1984). But the approach relies on standardized, end-of-pipe control technology to ease rulemaking and enforcement. It requires ever more stringent control measures when initial state steps prove insufficient. Moreover, it imposes uniform state- or nation-wide emissions limits for discrete industrial processes—no more than 0.3 pounds of hydrocarbon emissions per gallon of wire-coating applicator, and so on.

Yet removing a pound of hydrocarbon emissions from one coating line often costs 100 times more than removing that pound from an adjacent process. If the firm can remove that pound for $1 instead of $100, society saves $99 while the air realizes equal benefits. The problem is even more dramatic when emissions have already been reduced 80 percent and an additional 10 percent improvement is sought. Removing the last 10 percent usually is much more difficult and expensive than removing an equivalent amount from another process not subject to control.

Enter trading. It now seems settled that bubbles can elicit not merely large amounts of regulatory activity, but also significant economic and environmental benefits. By October 1984, EPA had approved or proposed to approve about fifty bubbles and was following over a hundred others. It had also approved or proposed to approve eleven "generic rules" authorizing states to accept individual bubbles without federal review, and a dozen more of these state rules were being drafted. Under accepted generic rules, states were reviewing about thirty bubbles and had approved twenty-five others, including the DuPont bubble. EPA had approved "banking" rules for Oregon, Missouri, and Rhode Island, and twenty-one more were being developed. Seven emissions banks were operating. An estimated 2,500 offset transactions had occurred, along with hundreds of "nets." These figures probably underestimate bubble-related activity, since EPA often does not learn of trades until states have approved them.

Even so, the benefits are large. By October 1984 the bubbles already approved by EPA had saved applicants an estimated $300 million over the costs of meeting traditional air pollution regulations, with state-approved bubbles saving millions more. Many of these bubbles were producing substantially more emission reductions than required by the original prescriptions; the rest were yielding equivalent reductions. Average savings on the hundred other bubbles being followed by EPA were estimated at $3 million apiece. As last autumn's leaves began to fall, estimated total savings from known existing-source bubbles alone approached $800 million.

Few other regulatory innovations had won so much support. Both Democratic and Republican administrations had hailed trading's focus on ends rather than means. Carter EPA chief

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Douglas Costle repeatedly declared that "the bubble means less expensive pollution control, not less pollution control." And Reagan regulatory czar Christopher DeMuth said:

> By harnessing rather than resisting natural market incentives, emissions trading will provide a more dynamic force for innovation in pollution abatement than the most ingenious "technology forcing standard" anyone could write down in the *Federal Register*. . . . [With trading] the prospect is we will spend less time at argument and more time at accomplishment in protecting our precious natural resources.

Congress's General Accounting Office had called for expanded emissions trading, while countries as diverse as West Germany, the Netherlands, Japan, and Mainland China were exploring the idea. Trading, in short, was widely seen in international circles as a model for constructive reform.

Bubble Blues

Yet trading's hold on regulatory practice remained tenuous. The banked emission reductions that GE used in Louisville, for example, had been deposited when Harvester shut down a plant. But that shutdown "might have happened anyway," it was argued, so no bubble "credit" should be given for the reductions. DuPont's bubble was open to similar objections. Perhaps the control equipment normally used on the plant's seven large stacks would have reduced their emissions by 99 percent anyway. If so, failure to control the smaller vents and valves might undermine rather than advance environmental "progress." Moreover, at the time of these trades, neither Kentucky nor New Jersey had in effect an EPA-approved state implementation plan showing how the state would meet national air quality standards. Without such a plan no reduction could be "surplus," since EPA could not know the amount of reductions needed for attainment or the factories from which those reductions would come.

Beneath such arguments lies the view that more emissions reduction is always better, that each possible increment of progress must be seized because there is no "stopping point" at which individual or cumulative reductions are truly sufficient. This view implies a goal of zero emissions. It is potentially fatal to any incentive-based approach that seeks to encourage performance better than required minima, since it threatens to convert each extra reduction into a new minimum requirement.

Beneath such arguments lies the view . . . that each possible increment of progress must be seized because there is no "stopping point" at which individual or cumulative reductions are truly sufficient.

And beneath this view lies the gulf between an idealized Clean Air Act and the way the act operates in practice. In the ideal world of the statute books, the states have complete inventories of pollution sources. SIP requirements are based on these inventories; firms' prompt compliance with these requirements will produce clean air by fixed national deadlines; and SIPs contain clear guidelines that citizens' groups can enforce. But in the real world, inventories are grossly inadequate; firms have reason to conceal emission sources or better ways of controlling them, so as to avoid becoming regulatory targets; and a "SIP limit" is only the starting-point for lengthy negotiation. Agencies do not know feasible ways to control many emission points; states merely impose requirements on industries thought able to bear the cost—or on future plants whose owners are not present to object. Compliance is routinely determined through self-certification by regulated businesses, and the air quality effects of genuine compliance are often uncertain. Moreover, a SIP can occupy ten file cabinets that no one has fully reviewed.

By the late 1970s, concerned parties had embraced emissions trading because it offered ways to begin bridging this gap between law and reality on an incremental basis, as bubble applications quantifying actual emissions and the effects of alternate control approaches were submitted. But in light of the act's detail and the literalism with which courts had interpreted it, there were serious legal questions regarding EPA's ability even to acknowledge the gap, much less develop innovations to cross it.

For example, the act as then interpreted required states to attain ambient air quality

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standards "as expeditiously as practicable" but in no event later than short prescribed deadlines—generally 1982. How could this leave room for any "surplus" reductions, since attainment would always be *more* "expeditious" if extra reductions were confiscated? The act appeared to require trades to produce equivalent ambient effects, to require EPA to ban industrial growth in areas not covered by approved SIPs, and to require any change in emission limits to be made through a formal "SIP revision" involving notice, public comment, and lengthy review before the state and EPA. How could these mandates admit trades that *shifted* (though they reduced) ambient pollutant concentrations, or that highlighted (though they improved upon) the inadequacies of previously approved plans, or that were sought by firms facing imminent compliance deadlines?

More important than these statutory questions were institutional ones. Trading would decentralize compliance decisions by transferring them to thousands of plant managers whose circumstances could not be anticipated by broad uniform rules. It would offer large savings to firms that came forward with better solutions. It would encourage plant engineers to talk to government engineers about how to solve problems, rather than spur lawyers to litigate responsibility for them. It could improve regulatory results *without changing regulatory mechanisms*—could accept the whole apparatus of ambient standards, state plans and emission limits, and simply invite firms to produce equivalent reductions less expensively.

[Trading] could accept the whole apparatus of ambient standards, state plans and emission limits, and simply invite firms to produce equivalent reductions less expensively. But these very virtues were . . . perceived as vices by regulatory staff and environmental groups.

But these very virtues were, and to some extent still are, perceived as vices by regulatory staff and environmental groups. With trading, compliance and enforcement would no longer be automatic determinations that standard end-of-pipe control equipment had been installed. Permit writers would have to estimate the effects of such equipment and the effects of proposed alternatives, in order to decide whether equivalent reductions would ensue. Such determinations would be made far from Washington, in ways difficult to limit through public rulemaking or the broad-brush regulations it produced.

Perhaps worst of all, trading might expose what one observer has called "the dirty linen of the Clean Air Act." All the deals cut in good faith to make the act work down in the trenches—the slipped deadlines, the convenient assumptions, the acceptance of less-than-ideal emission limits for the sake of significant reductions, the approvals of questionable state plans to avoid collisions between environmental and economic progress—would be dragged into the harsh light used to judge new departures.

Such deals are not of course unique to trading. They are endemic to pollution control, a necessary part of the discretion inherent in any regulatory system. With traditional regulation, however, it generally makes little difference if EPA approves, say, a rule demanding a 75 percent rather than 85 percent reduction in emissions from appliance coating lines. Meeting the looser limit still requires standard controls on each coating line covered by the rule. Nor does it make much difference whether a firm installing this equipment actually realizes a 75 percent or 95 percent reduction. In either case, "progress" is being achieved. But with trading, such differences become critical. Once firms are allowed to comply with emission limits in the *aggregate*, actual overall emissions may *increase* if regulators give one source credit for reductions that traditional compliance "may have produced anyway," since that credit could then be used to avoid control elsewhere. No matter that where prescriptive controls are costly enough to prompt bubble proposals, the likely alternative to the bubble is years of litigation and pollution as usual. No matter that in the absence of trades, many sources subject to traditional regulation will "comply" through variances that simply hike their emission limits. The "perfect" Clean Air Act remained the legal yardstick: "imperfect" trading was seen to undermine the maximum "progress" Congress had required. Indeed, Congress had piled statutory detail upon detail to *eliminate* regulatory

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discretion, to make the act as automatic as possible in order to hold the feet of EPA, state agencies, and regulated firms alike to the fire.

Stopping Points: A New Vision of the Clean Air Act

These considerations guaranteed that the trading initiatives would become lightning rods for much larger issues. Do midwestern states have power-plant emission limits that allow use of local high-sulfur coal, but are looser than the emission limits imposed by seaboard states whose utilities burn low-sulfur oil? Has EPA "failed to regulate" large numbers of toxic air pollutants because the act demands too much too soon? Is a statewide regulation for auto spray-painting not quite so stringent as *post hoc* control results suggest it could have been? By challenging individual bubble proposals, environmental groups could raise such issues under the banner of "progress," in ways that might tighten requirements for many sources at once. Indeed, the more EPA and firms came to value trades, the more environmental groups would see them as powerful regulatory levers.

An EPA serious about bubbles eventually had to . . . concede that some bubble reductions "might have happened anyway," and yet convince skeptics that further attempts to identify such reductions were just not worth the effort in light of the benefits that incentives achieved. . . . Only such stopping points would make the prospect of credit reliable enough to alter regulated firms' behavior.

So firms began to call these proposals "variances," "SIP revisions," "plantwide permits"—anything but bubbles. The label itself attracted too much attention; the rose by other names smelled more sweet.

An EPA serious about bubbles eventually had to confront these institutional barriers, admit that discretion was being exercised, concede that some bubble reductions "might have happened anyway," and yet convince skeptics that further attempts to identify such reductions were just not worth the effort in light of the benefits that this use of incentives achieved. In short, it was necessary to develop "stopping points" for traditional regulation that defined "equivalence" to standard controls and that refused to look beyond such equivalence, though some (unknowable) emitters would always achieve "more than standard" reductions by installing standard controls. Only such stopping points would make the prospect of credit reliable enough to alter regulated firms' behavior.

Thus, stopping points were crucial for emissions trading. However, the underlying issue was not merely bubbles, but use of incentive-based approaches to pollution control. For *any* significant shift from the prescriptive status quo would have raised the same questions about "equivalent" effects and the definition of "extra" reductions. At stake was the possibility of change itself, a new vision of the Clean Air Act—one which acknowledged that EPA could not predict each firm's emission-control performance, but also acknowledged that the last bit of pollution should not be wrung from each regulatory transaction because the quest for such perfection was ultimately self-defeating.

Under this new vision EPA would place dynamism above perfection, admitting—as one staffer remarked—that "the Act is a car with two wheels and three cylinders, and we're trying to make it go. It shouldn't have to be a Maserati before it can move at all." Instead the agency would seek continual movement toward attainment, discarding the fiction that each round of required reductions was the absolute, last, final one. The agency would make the inevitable next rounds easier to achieve, through incentives that encouraged companies to reveal rather than conceal necessary information. It would increase flexibility *and* certainty, by defining "equivalence" in ways that firms seeking to use bubbles could rely on and understand.

Stopping Points Enter the *Federal Register*

EPA's 1979 Bubble Policy was the agency's first major response to these opportunities for more efficient regulation (44 *Federal Register* 71780). The policy set two crucial stopping points.

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States with EPA-approved SIPs could grant firms credit for any emissions reductions below SIP limits. Even states without fully approved SIPs could grant firms credit for any emission reductions below the individual SIP limits that EPA had approved, and those credits could be used in trades with similar sources of pollution. In neither case would EPA attempt to play "gotcha" by questioning whether reductions below approved limits were "extra."

Unfortunately, under the new policy every bubble had to be treated as a "SIP revision" and therefore be processed through two or more levels of government—an eighteen-month procedure, on average. Bubbles generally could not be used where they promised the largest savings and environmental gains—in urban nonattainment areas. Applicants had to prove that their bubble proposals were "equivalent" to SIP limits through complex and costly mathematical modelling of pollutant dispersion from all emitters in their locale. Applicants also had to comply or promise prompt compliance with the stack-by-stack SIP limits their bubbles would replace. These requirements burst many bubbles even before they could be formed. But the savings made possible—25 percent of the parent firm's aftertax profits at one steel company, for example—ensured that bubble applications continued to arrive. Indeed, a string of early bubbles yielded more than "equivalent" reductions—they allowed some states to better their SIPs and achieve full attainment.

In 1981 EPA authorized states to approve certain classes of bubbles without advance federal review, declaring that SIP-equivalent trades under state "generic rules" approved by EPA were not "SIP revisions" (46 *Federal Register* 20551). This step cut a knot of procedural issues, and gave permit writers staggering under massive SIP-revision backlogs a substantial stake in the bubble's success. Equally important, it allowed EPA to reinterpret a "technology-based requirement" so as to focus on emission results rather than prescribed methods of control. The Clean Air Act directs states without fully approved SIPs to issue regulations requiring that existing sources use "reasonably available control technology" (RACT). The 1981 initiative declared that EPA, once it approved a state's RACT regulations, would cease to scrutinize the technology actually installed or the emissions reduction actually produced by emitters, provided reductions equivalent to these "RACT limits" were achieved. Different firms—a can maker and a coil maker on opposite sides of a city, for example—could thus use better-than-RACT emission reductions in bubble arrangements. In the jargon of the trade, such firms could "bubble RACT."

These developments were confirmed in the 1982 Emissions Trading Policy that replaced the 1979 bubble document and defined clear principles for approving any trade (47 *Federal Register* 15076). This policy established the emission reduction credit (ERC)—a reduction that is surplus, permanent, quantifiable, and enforceable—as the common currency firms could spend for bubbles, offsets, and nets, or could save in emission banks. (Trades without banks are "like canvassing your neighborhood for a home improvement loan instead of going" to the S&L, the Republican senator from New Mexico, Pete Dominici, had growled.) The policy also established a host of new stopping points. States could guarantee that banked reductions would never be seized to fulfill the act's "progress" requirements. States were authorized to adopt generic bubble rules covering large classes of pollutants and trades. Emitters were no longer required to model pollutant dispersion where models were likely to prove useless, and modeling requirements were restructured to protect air quality without penalizing firms whose bubble proposals identified and reduced deficiencies in existing SIPs. Finally, urban nonattainment areas were fully empowered to adopt bubble approaches, using RACT limits to define "surplus" reductions. Though "more than RACT" might someday be required, such limits were deemed sufficient until that day arrived. For the moment, dynamism had triumphed.

The Bubble in Ascent

The collective impact of these changes was profound. Industry now had economic incentives to *favor* pollution control—to reduce and bank emissions as early as possible, to ask that previously uncontrolled sources be regulated through bubbles, to develop and share new control strategies. And regulators saw that beneficial results could be achieved *voluntarily*, without the trouble of attempting to mandate

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further reductions across the board. After a decade of trench warfare, both parties might now be able to act together as good environmental consumers, substituting cheap surplus emission reductions for costly required ones, moving to expensive controls only after other options had been fully explored.

By 1984 emissions trading had begun to convert EPA from a policeman involved in each permit change at every regulated plant to a manager auditing state programs. Trading had also begun to change corporate behavior by increasing the importance of pollution control decisions, shifting them from cost centers concerned with minimizing damage to influential profit centers that decide where to invest company funds. And trading had shown what can happen when a good idea gets loose. Several acid-rain bills in Congress provided for trades across large regions to reduce the costs of enormous sulfur-oxide reduction programs. EPA authorized steel makers to meet Clean Water Act limits on a plant-wide basis instead of at each outfall, and national environmental groups promised to defend that bubble (49 *Federal Register* 21024). EPA also began to explore attainment of water-quality standards through bubbles covering industrial point sources, wastewater treatment plants, and nonpoint sources like farms.

Finally, the agency decided to authorize air bubbles covering new facilities subject to stringent new source performance standards (NSPS). This was a bold new "stopping-point" initiative. Emission limits set to attain ambient standards had always contained their own natural stopping point—regulatory flexibility was generally acceptable so long as progress toward target ambient conditions stayed on track. But NSPS applied to new facilities, *regardless of ambient conditions or effects.* They admitted no natural stopping point in regulatory demands because they were meant to minimize emissions by "forcing" the installation of standard advanced control technologies at such facilities. While many firms that installed these technologies might routinely perform better than NSPS emissions limits, granting them bubble credit seemed to contradict this emissions-minimizing goal.

Yet some claimed, and some evidence suggested, that NSPS *worsened* air quality by discouraging the steady replacement of old, high-polluting facilities with new, cleaner ones. Despite the uniformity of NSPS, the costs of meeting them often varied by a factor of 1,000 for adjacent new facilities. Indeed, one petition to EPA sought to meet NSPS requirements at two new facilities through a bubble that would yield 3,000 tons a year fewer emissions and $500 million lower control costs than separately imposed NSPS. Allowing such "compliance bubbles" might turn problems into environmental opportunities, if "equivalence" to NSPS could be satisfactorily defined.

The Bubble Descends

Unfortunately, the trading initiatives created regulatory uncertainty for regulators as well as industry. Comments raising several hundred issues were filed in response to the 1982 Emissions Trading Policy. The inevitable horrible examples appeared, including one bubble that purported to yield more reductions than participating facilities had ever emitted, and others in which firms sought credit for routine compliance that happened to produce ten times more reductions than required. In August 1982 the U.S. Court of Appeals for the District of Columbia invalidated nonattainment-area netting, declaring that "a bubble concept" could not be used in nonattainment regions, which were supposed to strive for maximum air-quality improvement. This decision addressed only a sliver of trading. But it appeared to adopt the "no stopping point" philosophy for all types of trades in these areas. Shortly afterward, the

Requiring each bubble to produce overall emissions reductions, rather than "equivalence" to inadequate SIP requirements, represented the only real chance of environmental improvement....

Clean Air Act's 1982 deadlines for achieving ambient standards expired. The standards had not, of course, been met nationwide; they had not even been met in many areas with previously approved SIPs.

These events revived numerous questions about the acceptability of trading. In particu-

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lar, they revived questions about what rate of "progress" was acceptable in nonattainment areas. Requiring each bubble to produce overall emissions *reductions*, rather than "equivalence" to inadequate SIP requirements, represented the only real chance of environmental improvement for state agencies unable to identify uncontrolled sources or issue further regulations opposed by governors, unions, and local industries. But admitting this fact would require EPA to acknowledge that direct regulation was insufficient to yield attainment. And this admission would in turn collide with the view that "extra" control in nonattainment areas should never "count" because it was needed—hence required—anyway. The "ideal" Clean Air Act was being reasserted.

EPA eventually divided into three camps on this bubble issue. One argued that bubbles should be banned in any nonattainment region until a new approved SIP defined what reductions were truly "surplus." A second camp argued that bubbles should be approved only after scrutiny of the *motives* behind emission reductions, to make sure those reductions would not "have happened anyway." Under this approach, a series of rebuttable presumptions would be used to ensure that reductions given bubble credit resulted *solely* from a desire to trade. Thus no credit would be given for reductions that occurred long before a bubble proposal was filed, or that resulted from "standard industry practice," or that seemed motivated largely by "other economic reasons" (insolvency, for example), or that were an inadvertent effect of normal compliance actions. The third EPA camp argued that bubbles should simply be asked to produce a "substantial air quality improvement" (a 20 percent reduction in remaining emissions) over what regulation-as-usual could have required.

The first camp reflected the traditional view that attainment is the regulator's sole business: economic advantages are not to be considered until attainment is guaranteed. But this position went too far. Restricting "surplus" reductions to those in excess of a complete SIP that guaranteed attainment would have banned not only existing-source bubbles, but also offsets, nets, and all economic growth in nonattainment areas—a result Congress had plainly sought to avoid in the 1977 Clean Air Act. Moreover, the position assumed that EPA could not approve any slice of a state's program until the whole SIP pie had been assembled. It would therefore have barred EPA from approving *any* additional state requirements that were not yet part of a complete plan, even though they would produce further emission reductions.

The second camp sought to maximize environmental benefits and legal defensibility by requiring general, 20 percent emissions progress *and* scrutiny of the reasons for each bubble emission reduction. But several factors argued against this subjective approach. Most obvious was the difficulty of formulating any objective test for "standard industry practice" or "other economic reasons." How many firms within the same or similar industries would have to use an emissions-control practice before it became "standard"? If part of an industry used emissions-free processes in California, would zero emissions become the universal "standard"? If a firm accelerated closure of an unprofitable facility in order to sell resulting credits, or installed extra controls partly to recapture valuable raw materials, should bubble credit be granted or denied? These questions promised to thrust EPA into unfamiliar arenas, to reward companies that took care to generate "proper" paper trails, but to penalize those that acted with unlawyerly common sense. They threatened the worst of both worlds —endless bubble reviews to establish corporate motives, with few bubbles actually approved. They also threatened to erase previous stopping points. If the question was no longer whether reductions below required levels would occur, but whether they would occur *solely for disinterested pollution-control motives*, few bubbles would be developed or proposed. Too many environmentally beneficial trades have ancillary economic benefits—increased productivity, better feedstock management, and so on. Under the subjective test, these benefits would all become reasons for rejecting bubbles.

The third EPA camp on bubbles argued that subjective inquiry would discard too much genuine progress in an attempt to isolate suspect motivation. A subjective test, it held, was fundamentally inconsistent with *any* use of incentive schemes. Such schemes recognize that real-world actions occur for many motives and seek to tip that calculus in favorable directions *on the actor's own terms*—to match private interests with public ones. Subjective tests would

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dissolve that match and impose a calculus that had little to do with reasons for which corporate managers act. Though some proposed bubble reductions might still "have happened anyway," this camp continued, a 20-percent-per-trade margin was more than enough to compensate for such cases. Indeed, the reductions required were sufficient to produce virtual nationwide attainment, had states been able to include them in general regulations.

As this debate within EPA proceeded, the Supreme Court struck a blow for stopping points. In *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.* (June 25, 1984), it unanimously reversed the D.C. circuit's 1982 netting decision: EPA, the Court indicated, is not required to insist on every potential reduction in nonattainment areas when the agency reasonably believes such efforts to be counterproductive. Bubbles, said the Court with approval, give "a plant manager flexibility to find the places . . . within a plant that control emissions most cheaply, [allowing] pollution control [to] be achieved more quickly"; even the act's NSPS section "implies a bubble concept of sorts." The decision applied only to bubbles for certain new sources in nonattainment areas. But because these sources are subject to the act's most stringent requirements, the Court's statements appeared to cover existing-source bubbles as well.

Nevertheless, the *Chevron* decision merely confirmed EPA's *discretion* to adopt stopping points; it did not *require* EPA to do so. The agency remained free either to grant bubble credit for many reductions below required emissions limits, or to deny credit by attempting to determine whether those reductions were selfless and simon-pure. Which path would EPA take? In a series of meetings ending in January 1985, the agency made its choice.

The Bubble Floats Free

EPA has now proposed to approve the first NSPS bubble (50 *Federal Register* 3688). Moreover, while details remain to be worked out, the broad outlines of the agency's forthcoming NSPS bubble and final emission trading policies now seem clear. EPA will opt for reliable stopping points that acknowledge the need for interim progress and the bubble's ability to se-

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cure it. It will tighten requirements for nonattainment-area bubbles, but in ways that make trades easier to use. The agency will neither psychoanalyze all bubbles in nonattainment areas, nor visit the sins of the past on future bubble applicants. Instead it will generally approve bubbles that meet objective threshold criteria.

For existing sources, a nonattainment-area bubble will generally be approved if it uses a RACT baseline to define aggregate threshold emissions, if it reduces emissions by 20 percent from that baseline, and if it does not rely on "past" reductions....

For *existing sources*, a nonattainment-area bubble will generally be approved if it uses a RACT baseline to define aggregate threshold emissions, if it reduces emissions by 20 percent from that baseline, and if it does not rely on "past" reductions effected before the application to trade or bank was filed. This last criterion will generally limit bubble credit to reductions below "actual" emissions—those current when an application is filed. Thus past horror stories involving bubbles that relied on preapplication reductions unrelated to trades will not be repeated. But the criterion will also give full credit for all reductions made in contemplation of trades—an approach that will recognize superior control efforts without attempting to unravel past motives or predict the actual performance of future, yet-to-be-installed controls. A few bubbles that meet these three tests may still be questioned. But strong presumptions will favor approval.

For new sources, bubbles that lump together facilities subject to NSPS will generally be approved if they yield emission reductions as great or greater than those that would flow from source-by-source compliance with NSPS.

For *new* sources, bubbles that lump together facilities subject to NSPS will generally be approved if they yield emission reductions as great or greater than those that would flow from source-by-source compliance with NSPS. EPA will defer writing precise definitions of "surplus" NSPS reductions until it has evaluated more NSPS bubbles. But such definitions appear inevitable, for the agency plans to allow bubble credit for reductions resulting not only from better-than-NSPS control equipment, but also from superior operation of standard equipment. Both steps require benchmarks defining what "superior" performance is.

These broad resolutions are important. They indicate that the agency will not debate again whether trades are impermissible because their reductions "might have happened anyway." They make "past" reductions easy to address without such inquiry: because such reductions have *already* happened, we know their precise amounts, which may generally not be used in subsequent bubbles. But bubbles are typically sought by firms attempting to meet *new* control demands less expensively. And since no one can predict whether a firm *proposing* to install specific control equipment will perform above or below target levels, surrogates for "equivalence"—for example, expected average performance for technology-based NSPS requirements—will have to be the measure of valid bubble reductions. Without such measures, EPA's resolutions suggest, plant managers could not be sure that extra reductions would be credited, so few reductions would be sought or disclosed. With such measures, managers will have continuing reasons to come forward with better pollution data and control methods. Though some "ideal" Clean Air Act reductions may be "lost" in the process, more real-world environmental progress will be made. That fact makes all the difference. ■

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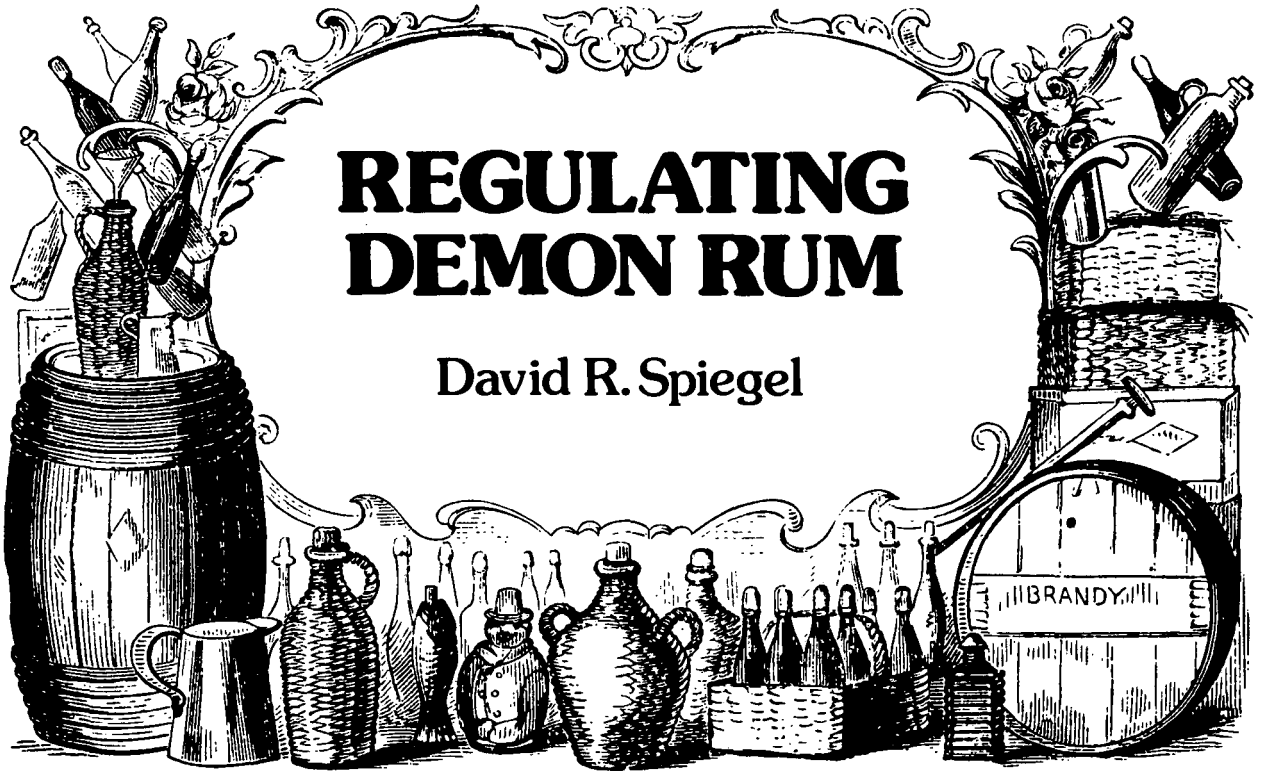

REGULATING DEMON RUM

David R. Spiegel

FOR MANY CONSUMER GOODS, the announced aim of regulation is to secure for the consumer the largest supply of goods of the highest quality at the lowest price. In the liquor business, however, these goals collide with another objective—preventing (or discouraging) excessive consumption of the product in question. As a result, many state alcoholic beverage laws wind up attempting to drive up price and curtail supply. The goal is not to prohibit the sale of liquor—the traumatic experience of prohibition cured most policy makers of that urge—but to achieve some sort of middle ground between prohibition and an unfettered market.

Under the banner of temperance, the fifty states have passed a great variety of laws regulating liquor distribution. To what extent these laws have reduced problem drinking is unclear. Their major effect, however, is often to benefit various local groups. Economist George Stigler has postulated that "as a rule, regulation is acquired by [an] industry and is designed and operated primarily for its benefit." In the liquor industry, this is especially true.

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The Constitutional Background

The Twenty-First Amendment, which ended this nation's fourteen-year experiment with Prohibition, included a clause (section 2) that guaranteed each state the right to control "transportation or importation" of alcoholic beverages destined for "delivery or use" within its borders. This clause reflected a mistrust of federal authority, which had been exercised badly, many felt, during the Prohibition era. A proposed third section to the amendment, which would have given Congress concurrent power "to regulate or prohibit the sale of intoxicating

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liquors to be drunk on the premises where sold," was deleted during Senate debate on the ground that it could be interpreted to justify federal supremacy over state efforts at liquor control.

Not surprisingly, given this legislative history, courts have construed the Twenty-First Amendment as giving each state virtual autonomy to structure its distribution system as it pleases and decide who, if anyone, it will license to participate in that system. "It is well established," the Supreme Court noted in *New York State Liquor Authority* v. *Bellanca* (1981), "that a state has broad power under the Twenty-First Amendment to regulate the time, places, and circumstances under which liquor may be sold." States have used this broad power to enact a variety of regulatory regimes, from total prohibition of liquor sales, which prevailed in Mississippi as recently as 1966, to the relative latitude that prevails in Nevada, where there are virtually no restrictions on advertising, store hours, or pricing. More relevant to this article is the distinction between "control" and "license" jurisdictions. In the eighteen "control" jurisdictions (as well as Montgomery County, Maryland), the government itself acts as the wholesaler and in most cases the retailer for distilled spirits. In the thirty-two "license" jurisdictions (as well as the District of Columbia), the government licenses private parties to perform the wholesaling and retailing functions.

And this is only a starting point. Within the control and license groups there are broad differences in individual laws. These are highlighted in a biennial publication, *Summary of State Laws and Regulations Relating to Distilled Spirits*, published by the Distilled Spirits Council of the United States (Discus, a Washington-based trade association and a leading source of data on the alcoholic beverage industry). For instance, three states—Mississippi, Utah, and Oklahoma—prohibit virtually all forms of advertising and other promotional devices. At the other end of the spectrum, nine states impose almost no restrictions. In between are thirty-eight jurisdictions (and the District of Columbia) that have their own idiosyncratic requirements—such as prohibitions on use of immodest or undignified women in ads, bans on any references to therapeutic effects of liquor, and prohibitions on portrayals of Santa Claus. Apart from advertising, there are also wide variations in credit laws (wholesale and retail), in price and discount restrictions, in import restrictions (from absolute bans to no restrictions at all), in what products retailers can sell other than alcoholic beverages, in restrictions on outside ownership interests, in licensing requirements, and in tax laws.

The result is a system that emphasizes knowledge of minutiae and legal trivia, with a Byzantine price structure that encourages consumers to evade local laws and shop for their favorite brand in a neighboring state. According to 1984 Discus price data, retail prices on the fifth size of certain name brands of liquor varied more than 100 percent from high to low jurisdictions. Wide fluctuations in a single region are commonplace. For example, in Kansas liquor prices averaged 79 cents a fifth higher than in neighboring states.

Social Policy

The ostensible policy goal of virtually all alcoholic beverage regulation is to promote temperance (or, in the more modern, "medical" parlance, reduce substance abuse). This goal is cited again and again in legislative debates and statutory preambles. Although other social objectives are sometimes mentioned—for example, keeping criminal elements out of the industry—they have a decidedly subsidiary role.

There is comparatively broad agreement among industry analysts that the surest way to reduce liquor consumption is to raise the price of liquor.

There is comparatively broad agreement among industry analysts that the surest way to reduce liquor consumption is to raise the price of liquor. How big a price rise is needed to bring about any given cut in problem drinking is unclear. But one thing appears certain: keep raising prices and at some point, all else remaining constant, consumption will drop.

The obvious way to drive up the price of liquor is to tax it, and all fifty states do so. But most states go further, attempting to control or

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influence the price at which liquor is sold. The states with liquor monopolies use markup formulas to set a uniform shelf price for each brand. The others mostly use more indirect regulatory means toward the same end.

Formerly, many license states used "mandatory markup" laws that required retailers (or sometimes distributors) to mark up prices by a stipulated minimum percentage. However, such laws have become increasingly unpopular. They put the state in the role of a price-fixer or an accomplice to price-fixing arrangements, without actually letting it take charge of the distribution apparatus. Only three states—Wisconsin, Kansas, and New York—have retained markup formulas, and in one—New York—two separate state courts have recently found that the practice violates federal antitrust laws. These decisions are currently on appeal to the state's highest court.

In the absence of markup laws, license states attempt to influence price through a variety of indirect restrictions affecting the conditions under which liquor is sold or wholesaled, who may sell it, and which consumers may buy it. However, these restrictions (many of which are also in force in control states) have only an incidental impact on price, and create a number of unpredictable nuisance costs for consumers, as will be shown later. They also have certain not-so-incidental effects, oftentimes designed for the benefit of local business interests and having little or nothing to do with consumer welfare.

The Interest Group Factor

It is an article of faith among state liquor regulators that only vigilant law enforcement can thwart control of local liquor retailing by unwholesome out-of-state suppliers. This attitude has its roots in the pre-Prohibition view that the major devils leading innocents down the primrose path to intemperance were the distillers and brewers and the "tied houses," or retail establishments, that they dominated. The regulatory solution was not unlike that proposed for the oil companies in the 1970s: vertical divestiture. The thirty-three states with private liquor systems adopted a "three-tier" distribution system, separating the liquor industry into (1) suppliers (usually distillers or importers), (2) state-licensed "distributors" or wholesalers, and (3) retailers.

On the surface, this three-tier system looks much like the distribution system used for other common products such as groceries or soft drinks. What makes it different is the enormous restrictions all license states place on dealings between the tiers. The wholesaler, in particular, is supposed to serve as a kind of buffer separating local retailers from the machinations of the faraway suppliers. This system may have succeeded in wiping out the lobbying influence of the suppliers. Unfortunately, it has turned the local tiers—the retailers and particularly the wholesalers—into potent interest blocs of their own.

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In state lobbying battles, distributors and retailers tend to portray themselves as local underdogs besieged by wealthy outsiders. The true picture is more complicated. Retail liquor stores in most states commonly gross more than $1 million a year. About half of all American supermarkets now carry wine, and in some states (notably California) they sell liquor as well. Many of them have corporate ties outside the jurisdiction. Although "mom and pop" stores remain a major factor in some states, it is mostly because collective lobbying has kept out competition by chains. In Kansas, a state study found that the typical retailer earned just $8,194 in 1980, and that there were considerably more liquor stores per capita than in comparable states.

Distributors are even larger. Recently released census figures show that the typical wine and spirits wholesaler had mean annual sales in 1982 of more than $11 million. That is probably an underestimate, because the census figures treat as separate entities many seemingly distinct licenses and warehousing facilities that in fact operate as a system. In New Jersey, according to a 1978 report by the state attorney

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general, five groups of wholesalers, each group financially interlocked from within, held twenty-four licenses and accounted for more than 80 percent of the distilled spirits sold by state retailers. In New York City, six dominant wholesalers were estimated to do more than $700 million in sales collectively in 1979.

Nonetheless, local firms, particularly wholesalers, have had remarkable success in securing laws to protect their interests. Take, for instance, franchise protection—an area where regulation has become increasingly popular in recent years. According to a 1984 report prepared by the Wine Institute of America—a California-based trade association—forty-two states apply such laws to one or more alcoholic beverages, seventeen of which apply them only to distilled spirits.

The purpose of franchise protection laws is to limit the supplier's freedom to terminate or modify sales arrangements with distributors. Typically, these laws require the supplier to show "cause" if it wishes to switch distributors and the distributor objects. The administrative and judicial requirements for establishing cause effectively block all but a handful of franchise shifts. They also inhibit significant modifications of existing sales arrangements.

The effect, of course, is to insulate established distribution houses from competition by new entrants. This occurs because in most markets, either as a result of historic practice or requirements in state law, franchises are commonly awarded to one or, at most, two distributors. As a result, newcomers cannot enter the market because they cannot find the popular brands that are indispensable for successful entry. Liquor is an area with strong brand loyalty; more than half of the national liquor case sale volume in 1980 was generated by thirty-six brands.

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In a majority of license states, distributor influence is augmented by "primary source" and "at rest" laws. The former forbid out-of-state suppliers from selling to wholesalers in the state unless they are the principal American supplier of the brand in question. The latter require out-of-state suppliers to sell liquor only to licensed state distributors rather than directly to retailers. The effect of both kinds of laws is to prevent wholesalers or retailers from undercutting established distributors.

One example of the way such laws work is the recent severing of the "Oklahoma connection" that linked California retailers to Oklahoma distributors. The link arose because distributors in Oklahoma were willing to sell popular, brand-name spirits at prices below those of established distributors in California. California retailers sought to take advantage of the price differences by importing out-of-state liquor through in-state wholesale operations that were outside the established network. This strategem, however, was short-lived. After an outcry from the established distributors, the state legislature passed a law permitting a supplier to designate a local distributor for its products and then forbidding California retailers from buying the products from another source.

Another link in the system consists of state "posting" laws. These require distributors to notify state regulatory commissions of their prices for all brands, publish these prices regularly, and keep them the same during the "posting period." More than half the license states, including such high-consumption jurisdictions as New York and California, have such laws.

Posting laws can inhibit price competition in two ways. First, since a price-cutter knows that its discounts will probably be matched by competitors, with a mutual loss of income, there is a strong incentive to preserve the status quo. Second, posting provides a mechanism for direct collusion. This latter problem was the subject of a 1982 Department of Justice case against six New York State wholesalers. The case, *United States* v. *Charmer Industries*, ended when wholesalers agreed not to exchange prices and discounting information. In New Jersey, a 1978 report prepared by the criminal justice

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division of the state attorney general's office referred to a pattern of close, possibly collusive conduct between suppliers and distributors arising partly as a result of the state's posting laws. The relevant provision, which was subsequently changed, permitted distributors to amend prices in their filings after viewing postings of competitors.

A number of states also require suppliers to offer wholesalers in the state at least as low a price as they have charged any buyers in other states during the preceding month. This sort of "most-favored-nation" clause (called an "affirmation law" by the industry) creates pressure for a single nationwide price rather than prices which take into account consumer preferences in different regions.

This practice was upheld in a 1966 Supreme Court case. However, a more recent variant passed by Connecticut in 1981 has been found unconstitutional. That law provided that beer suppliers could not charge Connecticut distributors more than the lowest price they offered in neighboring states. (Consumers had been crossing the border to New York State to buy beer.) Unlike the usual statute, the price comparison was to apply prospectively; suppliers had to give Connecticut the best price they were *planning* to charge in an adjacent state during the next posting period. Beer suppliers challenged the law in court, and the United States Court of Appeals for the Second Circuit eventually declared that it violated the Commerce Clause.

Court Challenges

In recent years there have been a number of court challenges to state laws and regulations. Although the possibilities of change through this approach appeared promising after a 1980 Supreme Court decision involving the federal antitrust laws, subsequent cases suggest that any optimism was premature.

The 1980 case—*California Retail Liquor Dealers Association* v. *Midcal Aluminum*—invalidated a California pricing statute that required suppliers and distributors to set a joint retail price for their offerings and then file this with the state liquor commission. Such a law, the Court said, constituted price-fixing forbidden by the Sherman Antitrust Act.

The case marked the first time that the Court had used the Sherman Act to invalidate a state's regulatory prerogatives in this area. In so doing, the Justices specifically rejected California's argument that its right to pass such laws was shielded by the Twenty-First Amendment. They also turned aside a contention that the laws were a form of "state action" protected from antitrust scrutiny under a principle dating back to *Parker* v. *Brown* (1943). Both of these defenses had heretofore been viewed as almost foolproof.

Two years later, however, in *Rice* v. *Norman Williams*, the Court signaled that antitrust suits against state price regulation were likely to be kept on an extremely short leash. A California state court had struck down the state's attempt to sever the Oklahoma Connection as a violation of the Sherman Act. A unanimous Supreme Court overruled the state court, declaring that a state statute would be preempted by the Sherman Act only if the private conduct that it mandated "necessarily constitutes a violation of the antitrust law in *all* cases" (emphasis added). This requirement of *per se* illegality, as any antitrust lawyer knows, imposes a heavy burden on prospective plaintiffs because such violations are comparatively rare and can probably be avoided by artful legislative draftsmanship. Moreover, the state action defense to antitrust scrutiny was given a new boost by two decisions during the Court's present term—*Southern Motor Carriers Rate Conference* v. *United States* and *Town of Heille* v. *City of Eau Claire*. In future liquor cases, the antitrust focus will probably return to the conduct of the private parties rather than the effects of state laws on competition.

State statutes have also been invalidated when they conflicted with constitutional provisions and when a balancing test suggested that there was no significant local government interest on the other side. For example, a Massachusetts law granting churches the right to veto license applications for liquor stores or bars within 500 feet of their premises was found invalid under the Establishment Clause. In its term ending 1984 the Supreme Court invalidated a provision of a Hawaii excise tax that favored local liquor producers. The Court found that this improperly burdened interstate commerce. In the same term the Court also invalidated on First Amendment grounds an Okla-

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homa statute that the lower courts had construed to prohibit liquor advertising on cable television.

The more typical judicial reaction, however, is to yield to state discretion. Thus courts have upheld state-enforced mandatory markups for retail prices, exclusive dealing requirements, a ban on advertising, and, to move afield a bit, restrictions on topless and bottomless bars.

A New Perception

As I have suggested, there is a wide variety of alcoholic beverage regulations that can be addressed in piecemeal fashion through court challenges or through legislative amendment. However, this is only a first step. Effective reform of liquor control policy involves an altering of deep-rooted perceptions.

State liquor regulation is driven by suspicion of the give and take of a competitive market. To permit market supply and demand to determine price is to risk intemperance. Thus any law that might conceivably reduce supply or increase price can be rationalized as pro-consumer.

State liquor regulation is driven by suspicion of the give and take of a competitive market. To permit market supply and demand to determine price is to risk intemperance.

This view is unfortunate. It overlooks the fact that many so-called pro-temperance provisions—advertising laws, promotion restrictions, limitations on what liquor stores can sell, on when they can be open—affect price only by attaching quixotic "dead-weight" costs to the purchase of liquor. Moreover, such provisions may backfire. For example, if strict closing hours are enforced, many consumers may make their liquor purchases on the way home from work instead of on an "as needed" basis —or they may stockpile liquor at home, tempting themselves to drink more. If liquor stores are forbidden to sell food, consumers might have to drive to a second store for potato chips and dip instead of making all their purchaes in one place—or they may buy the liquor but go without snack food, thus suffering the ill effects of drinking on an empty stomach. These indirect impacts are undoubtedly annoying to consumers, but it is hard to know how much effect they have on temperance.

. . . many state laws that act to raise prices are mere interest-group provisions masquerading as temperance laws. . . . To encourage (or wink at) anticompetitive conduct in the name of temperance is to waste the wages of sin.

Furthermore, many state laws that act to raise prices are mere interest-group provisions masquerading as temperance laws. These simply transfer monies from consumers to the private interests that sought the provisions. A more efficient means of raising liquor prices would be through a direct tax. Although liquor tax policies vary widely from one state to the next and are frequently at cross-purposes with the jurisdiction's other regulatory policies, this method at least guarantees a direct revenue flow to public coffers. To encourage (or wink at) anticompetitive conduct in the name of temperance is to waste the wages of sin.

Nor is the prescription for liquor control practices by the monopoly states without significant costs. State liquor store systems have been criticized for skimpy brand selection and variety, inconvenient store locations, inflexible pricing, and general unresponsiveness to consumer demand. And government bureaucracy is a vested interest of its own, susceptible to patronage pressures and interest wielding by local politicians. Worse, it is an interest group emancipated entirely from the pressures of the competitive marketplace.

IN THE FINAL ANALYSIS, perhaps the most significant lesson of the post-Prohibition era is that government regulation is inherently limited as a way to promote temperance. Fifty years after Prohibition ended, this lesson has yet to be learned. ■

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Readings
of particular interest

New Economic Reasoning at the High Court

"The Supreme Court, 1983 Term—Foreword: The Court and the Economic System" by Frank H. Easterbrook, in *Harvard Law Review*, vol. 98, no. 1 (1984), pp. 4-60.

Scholars who look at the Supreme Court's treatment of economic matters often carve the field into isolated subjects. They treat administrative law as one issue, antitrust as another, rate regulation as another. The author of the foreword to the *Harvard Law Review*'s annual survey of the Supreme Court's term argues that this is shortsighted. Several general principles cut across many economic cases. The Court's understanding and application of these principles has changed dramatically in the last thirty years, with results that affect its work in every subject area.

"Judges both resolve disputes and create rules," the author notes. Litigation tends to concentrate judges' minds on dispute resolution, on the question of how to divide gains and losses among the parties to a suit. By the time the parties appear in court, it is too late for them to change their past behavior. But the Supreme Court is concerned less with results in particular cases than with prospective rules. "The principles laid down today will influence whether similar parties *will be* in similar situations tomorrow," Easterbrook writes. "Indeed, judges who look at cases merely as occasions for the fair apportionment of gains and losses almost invariably ensure that there will be fewer gains and more losses tomorrow." When the Court distinguishes cleanly between the forward-looking effects of rules and the backward-looking arguments based on fair divisions of the stakes, he says, it substantially improves its decision making. Easterbrook lays out more than 100 cases to illustrate his claim that the Court of thirty (or even ten) years ago was concerned with stakes-division, while the Court today is concerned with the effects of economic rules on future behavior. He concludes that this change in emphasis has affected the Court's treatment of almost all of the economic issues that come before it.

Even if judges look for the probable effects of their rules, there is no guarantee that the results will be satisfactory; their analysis may still be faulty. For many decades, for example, the Court overlooked the elementary difference between marginal and average effects. Thus, an opinion on patent law might reject a particular claim by the patent holder on the ground that the patent would yield a large enough profit in any case. "Enough" meant on average; the Court was unconcerned about the benefits and costs of the particular provision on the margin. As an economic matter, though, average effects may be irrelevant; people adjust their behavior according to the gains and losses on the margin. More recently the Court's analysis in this area has grown more sophisticated. In the video copying ("Betamax") case last term, for example, it repudiated the sort of arguments it used to accept and asked how a marginal change in the copyright holder's ability to collect royalties would affect its incentive to make new movies and put them on the air.

Finally, Easterbrook argues, even sophistication about the difference between margins and averages would be of little avail if the Court had a romantic view of statutes. It is possible to treat statutes as indicators of "problems" or "evils" that the legislature insists must be redressed. The Court's role, in this view, is to find and expunge every instance of the evil, no matter what the cost. This method of statutory construction, prevalent for many years, is built on two premises, the author says: that all laws serve the "public interest" and that the more public interest there is the better. "The statute's reach goes on expanding so long as

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there are unredressed objectionable results," since there cannot be too much of a good thing. "The judge interprets omissions and vague terms in the statute as evidence of want of time or foresight and fills in these gaps with more in the same vein."

Other judges view economic statutes quite differently, as contracts between contending parties. Some laws have little purpose but to enrich the interest groups that lobbied for them. (Much of the deregulation movement is based on this latter perception.) A judge with this view "implements the bargain as a faithful agent but without enthusiasm; asked to extend the scope of a back-room deal, he refuses unless the proof of the deal's scope is compelling," Easterbrook says.

This latter view has now caught on at the Court. The justices now regularly treat statutes as contracts among interests, asking not whether there is some unredressed problem but what each interest group was or was not promised as a term of the deal. The Court recently adopted such a line of reasoning in the case of *Silkwood* v. *Kerr-McGee Corp.* when it held that Congress did not immunize the nuclear industry from state punitive-damage suits for nuclear contamination, even though there is extensive federal regulation of the nuclear power industry. Easterbrook concludes that the Court now sitting is more astute about economic matters than any group of justices in a long time, and that the increased sophistication in things economic has brought about substantial improvements in the law as it applies to the economic system.

Liability unto the Third and Fourth Generations?

"The Achilles Heel of the Takeover: Nature and Scope of Successor Corporation Products Liability in Asset Acquisitions" by Robert J. Yamin, in *Harvard Journal of Law and Public Policy,* vol. 7 (Winter 1984), pp. 185-259.

When one corporation acquires another, it often does so by buying the assets of the target firm rather than by carrying out an outright merger or consolidation. One important reason is that an arms-length purchaser of assets, unlike the surviving firm in a merger, traditionally need not assume the legal liabilities of the seller. This generally holds true even if the acquirer continues the seller's operations essentially unchanged and even if the seller is dissolved or liquidated after the sale and thus becomes unavailable to satisfy the claims of plaintiffs harmed by its past actions. The advantage of this old and well-established general rule is that it promotes predictability in corporate transactions, free availability and transferability of capital, and mobility in the business and economic world in general. By reducing the uncertainty associated with transfers of property, such as asset purchases, it opens the way for more transfers that put assets to more productive use.

One of the consequences of freeing successor firms from liability, however, is that some injured plaintiffs will not be compensated for their losses. On one reading, this outcome might not be deemed unfair to plaintiffs. After all, it is undisputed that a company can escape yet-unfiled liability claims by liquidating itself. In the case of an asset purchase, the potential defendant receives cash or property equal in value to the assets it sells and thus remains, along with its cash or new property, momentarily available to be sued—although, of course, it is selling its assets precisely because its owners or managers plan to dissolve or liquidate it shortly thereafter. Lawyers for potential plaintiffs, however, object that in an asset purchase, unlike a liquidation, the business itself is continuing, even if under new ownership. If in some sense the liability adheres to the business as a business, and not its now-defunct owners, a rule of successor nonliability allows it to get off scot-free.

Sympathetic judges, swayed by such arguments, have begun awarding damages against successor corporations, but only on behalf of one kind of plaintiff: individuals who have been injured by the defunct corporation or by the products it has manufactured. To achieve this outcome, the courts have created or expanded exceptions to the general rule against successor liability in asset purchases. Robert J. Yamin, a corporate practitioner with the Hartford, Connecticut, law firm of Day, Berry & Howard, describes in this article how the law has been changing in this area and explores the policy implications of those changes. He divides the

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theories courts have invoked to place liability on successor corporations into four main categories: the "mere continuation" exception to the general rule, the "de facto merger" exception, the "product line" theory, and the "duty to warn" theory.

The "mere continuation" exception originally provided for liability in cases where the legal and economic owners of the successor corporation were essentially the same before and after the asset sale transaction. Some recent courts have begun invoking this exception even in cases where the new owners were clearly quite different from the old, so long as the underlying business continued in operation. The "de facto merger" exception applies in cases where courts find, among other things, that the predecessor firm's stockholders continue to hold a strong equity interest in the successor corporation, usually when the purchaser used its own stock to pay for the assets that it acquired.

The "product line" test, first enunciated in a landmark California Supreme Court case (*Ray* v. *Alad Corporation*, 1977), is more sweeping. It charges the successor with liability so long as there is substantial continuity of the offending product line after the asset sale. The rationale is that the buyer is entitled to enjoy the sweet of whatever "good will" accompanies the seller's product line only if it chokes down the bitter of successor liability as well.

The "duty to warn" theory holds that a successor corporation has an affirmative duty to warn customers, the public, or both that products manufactured by its predecessor may be defective. Unless the successor firm issues such a warning—and in practice it may be difficult if not impossible to discover and publicize all past product flaws—it is exposed to successor liability.

The "product line" and "duty to warn" theories have proved to be the most potent routes to successor liability, Yamin says, although jurisprudentially they are at opposite ends of the spectrum. The product line theory is a highly novel approach, abandoning as it does any pretense of remaining within the corporate law regime in favor of a theory of strict products liability imported from tort law. Courts adopting the "duty to warn" approach, on the other hand, claim only to be applying a mere exception within the general framework of corporate law. Precisely because the "duty to warn" theory can be applied without the appearance of "judicial activism," Yamin says, it may prove to be the most versatile and powerful of all the theories adopted by courts to find successor liability.

Critics have charged that by bending traditional principles to protect consumer plaintiffs, the courts are harming the economic climate and increasing the cost of litigation. Nonetheless, in the author's opinion, the expansion of successor liability is likely to continue. But, he adds, things could be a lot worse for the business community. Not only have even the most plaintiff-oriented courts refused to find successor liability in product liability cases not involving injury to individuals, but they have consistently reaffirmed the general rule freeing successors from all of their predecessors' other debts and liabilities outside the products liability area.

Even the California Supreme Court, in its seemingly radical *Ray* opinion, emphasized that the narrow "special exception" it was creating "imposed no liability upon [the successor corporation] for [its predecessor's] obligations other than certain contractual liabilities that were contractually assumed" and stated that the general rule's "insulation . . . of a corporation acquiring business assets has the undoubted advantage of promoting the free availability and transferability of capital." The author concludes by listing preventive strategies by which purchasers might help avoid successor liability and "ameliorative" strategies by which they might lessen the impact of such liability where that risk cannot be avoided.

Tying the Chains in Knots

"Winners and Losers under the Robinson-Patman Act" by Thomas W. Ross, in *Journal of Law and Economics*, vol. 27, no. 2 (October 1984), pp. 243-271.

The 1936 Robinson-Patman amendments to the Clayton Antitrust Act were born during a period of intense rivalry in the distributive trades. The old wholesaling-retailing order was being threatened by innovative new entrants, including mail-order houses, door-to-door salesmen,

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and department stores. None was more threatening to the livelihood of the thousands of small independent wholesalers and retailers than the chain store. And in no field had the new chain systems become so powerful as in grocery retailing. From a retail market share near zero before 1890, grocery chains had come to account for about a third of all retail grocery sales by 1929.

Independent retailers and wholesalers did not take this invasion lying down. Warning of an imminent monopoly of retailing, they initiated a spirited public debate on the "chain store problem." Legislators at both the state and federal levels responded to these concerns in a number of ways; among them were special taxes on chains and the federal Robinson-Patman Act.

The Robinson-Patman Act prohibits differences in price that may be injurious to competition. It was directed at the discounts that chains were receiving from their suppliers. These discounts could often be cost-justified, since the chains frequently provided services for which suppliers otherwise would have had to pay middlemen. Though the law does allow for a cost-justification defense, this defense has been a difficult one to prove; indeed, some legal scholars have called it "impossible."

This study, by Thomas W. Ross of the University of Chicago and Carleton University in Ottawa, begins by examining the effects of the law in the 1930s on some of the principal economic actors of the time. Employing the techniques of capital market analysis, Ross assembled portfolios of common stocks in companies operating chain systems and then examined these portfolios for unusual movements attributable to the passage of the act. The results suggest that the law's adoption did substantial damage to the value of the six companies in the grocery-chain portfolio. The effects here were both large (an abnormal, negative return of 58 percent over thirty-one months) and highly significant statistically.

Though there was evidence of some damage to the values of the chains in the variety, department store, and drug fields, it was much less and statistically insignificant. This is consistent with earlier claims that the grocery chains (by far the largest chains in the 1930s) were the chains that benefited most from preferential treatment by suppliers. It is also partly explained by the fact that a large fraction of enforcement activity was directed at the grocery-store industry.

When the act was passed, some thought it might confer benefits on manufacturers of grocery products. By prohibiting them from giving discounts to the big chain buyers, the law could have kept them from engaging in vigorous price competition. Ross studied the effects of the act's passage on the stock value of a group of large grocery manufacturers, however, and found that they may have actually been hurt as well, though once again the effect was statistically insignificant.

The big winners of the period appear to have been the food brokers. These middlemen found protection in a part of the act that prohibited the payment of brokerage fees (or discounts related to brokerage savings) except to true food brokers. Thus, even if a large grocery chain performed all the brokers' functions (as the large chains did), it could not be compensated by the suppliers, even indirectly. This provision led to a sharp reversal in what had been the sagging fortunes of food brokers. The rough estimates provided suggest that the act may have boosted commissions to food brokers by as much as 19 percent in 1939.

The second part of the article analyzes the effects of Federal Trade Commission enforcement of the act to determine whether or not its activity in this area matters. Since the typical punishment on conviction for a Robinson-Patman offense is simply an order to cease and desist, one might justifiably wonder about the law's potency.

Again Ross employed capital market analysis to study these effects. He compiled a sample of fifty-five cases resolved since July 1962 (when the necessary stock price data became available) and assembled three more stock portfolios. The first included firms that consented to cease and desist before any judgment was rendered. The second consisted of firms that fought the charges and lost, thereupon receiving orders to cease and desist. The last portfolio contained firms that fought and won dismissals of the charges.

Firms in all three groups were hurt by the Robinson-Patman proceedings. Probably the most interesting result is that the firms signing consent orders seem to have been hurt the most. In the period from thirty-five days before the

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order was announced to fifty days after, they lost, on average, almost 10 percent of their market value.

When firms fought and lost, their stock prices fell about 5 percent in the days bracketing the announcement of the full commission's decision. More curious, when firms fought and *won*, their stock still fell and by almost as much (4.5 percent) as if they had lost.

The fact that the firms in the consent portfolio suffered the most might possibly be explained by self-selection, the author suggests. Perhaps the firms in this group were the worst offenders who, certain of losing, surrender quickly. Because their violations were the most serious, the consent order could be expected to bind them most tightly. It is much harder to explain why firms that fought and won were hurt as much as firms that fought and lost.

Reagan's Record Revisited

The Reagan Regulatory Strategy: An Assessment edited by George C. Eads and Michael Fix (Urban Institute Press, 1984), 227 pp.

In its first days, the Reagan administration began a much-publicized program of regulatory relief aimed at restoring productivity and growth to the economy. It created a task force to launch and sustain major reform initiatives, and targeted certain major industries for special relief; it centralized many powers of regulatory review within the Office of Management and Budget; and it called on Congress to amend major regulatory statutes and give back more regulatory authority to the states.

This volume consists of six papers assessing the Reagan effort up to June 1983. Editors George Eads and Michael Fix write that by then the program had run into considerable resistance in both Congress and the courts and seemed to be turning from a political asset to a liability. The policies of the Environmental Protection Agency, the Department of the Interior, and OMB had generated especially heated controveries.

The first paper in the anthology is by Murray Weidenbaum, the first Reagan chairman of the Council of Economic Advisers and also chairman of President-elect Reagan's transition task force on regulatory reform. He notes that the administration has succeeded in cutting regulatory agency budgets and staffs, though some of the cutting might be counterproductive from a deregulatory standpoint. For example, if environmental permit-granting staff are cut but have undiminished statutory duties, the time and cost of regulation could actually increase. On the other hand, he says, not much was done to reform regulatory statutes. And there is an even deeper problem: "The necessary foundation has not been laid in terms of public understanding and support for reducing the burdens of regulation."

In the next paper, Gregory Christainsen and Robert Haveman assess the impact of regulatory relief on productivity during Reagan's first eighteen months. They assume that reductions in regulatory outlays by government and business result in dollar-for-dollar savings in business costs. Accepting (without endorsing) the cost savings claimed by the administration for its deregulatory program, they estimate an average resulting increase in annual productivity of 0.15 to 0.3 percentage points. Using a different methodology, they estimate that regulatory reform raised the growth rate of labor productivity between 1981 and 1982 by 0 to 0.15 percentage points. Unless new cost savings are found on an ongoing basis, however, this marginal improvement will dissipate within a few years. The authors warn that all their numbers should be interpreted with great caution.

One of the industries targeted for special relief was the auto industry, examined by Robert Leone. In April 1982, amid fanfare, the administration announced a package of thirty-four specific regulatory actions to help the auto industry, and provided forecasts of the higher auto sales and employment levels that it believed would result. These goals were not met on schedule, however, and sales figures remained low for some time due to the continuing economic slump. Although it is hard to sort out the various influences, among which were the voluntary Japanese import restraints, Leone believes regulatory relief contributed only modestly to the revival of industry profits.

Another goal of the administration, restoring state and local regulatory authority, had to some extent already been contemplated by existing legislation and was thus easier to implement than some other measures. Michael Fix

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believes such devolution will have more enduring results than many other Reagan initiatives, but maintains that the administration is not entirely consistent on this issue. It is too ready to preempt the states when that is needed to pursue its other regulatory goals.

Jerry Mashaw and Susan Rose-Ackerman develop a conceptual framework for examining how regulatory power is allocated between the different levels of government in the federal system. Officials at each level seek to garner the credit for dispensing regulatory benefits while shifting the costs of the program to other levels of government. As for industry, its preference will depend on (among other things) how much bargaining power it thinks it can muster at each level of government. Mashaw and Rose-Ackerman assess the arguments deployed by advocates of federal and state authority on such grounds as democratic responsiveness, administrative efficiency, and economies of scale, and conclude that the Reagan administration oversold state decentralization as a solution to regulatory problems.

The final paper, by Christopher Foreman, examines the role of congressional oversight in the regulatory process. He categorizes the various ways Congress can keep a rein on regulatory bureaucracies, arguing, among other things, that the proliferation of committees and subcommittees with overlapping jurisdictions provides a healthy check against the "capture" of committees by the agencies they oversee. Foreman briefly reviews Congress's record, explores proposed new oversight tools, and concludes with policy recommendations.

Newcomers in the Deregulated Skies

Deregulation and the New Airline Entrepreneurs by John R. Meyer and Clinton V. Oster, Jr., with Marni Clippinger, Andrew McKey, Don H. Pickrell, John Strong, and C. Kurt Zorn (The MIT Press, 1984), 240 pp.

At the time the Airline Deregulation Act of 1978 was passed, forty years of regulation had thwarted most forms of entrepreneurship in the airline industry. The 1978 act created new opportunities for the established airlines and, perhaps more significant, also made it possible for entirely new competitors to enter the market. The rebirth of entrepreneurship in the industry took two major forms. First, entirely new jet-equipped carriers like People Express sprang up to offer simple, no-frills service with low fares in short to medium-haul markets, while a number of other carriers that had been previously confined by regulation to intrastate operations, like Southwest Airlines, seized the chance to expand. Second, there was a surge of growth and new entry by commuter airlines operating small propeller-driven aircraft in short-haul low-density markets.

This book, by John R. Meyer of the Kennedy School of Government at Harvard and Clinton V. Oster, Jr., of the School of Public and Environmental Affairs at Indiana University, and their colleagues, examines the demand and cost characteristics of the industry, the business strategies of the new entrepreneurs, and a number of related public policy issues such as the safety record of commuter airlines, the problem of limited airport access, and the federal program of subsidies for small community service. They find that entry by airlines has contributed to three of the main outcomes of deregulation: the broadening of fare and service choices, productivity and cost improvements, and the rationalization of small-community service. A recurring theme is that the new airline entrepreneurs have imposed new competitive pressures on the established carriers far out of proportion to the volume of traffic they carry.

Many reformers had expected deregulation to lead to across-the-board fare cuts, since the unregulated intrastate markets of Texas and California were generally characterized by low fares. But the established carriers at first responded to their new pricing freedoms with targeted discounts rather than general cuts. These discount fares were capacity-controlled (available for only a limited number of seats on each flight) and market-segmented (restrictions kept business travelers from using them). The new entrants countered by offering low fares in a simpler unrestricted format, thus attracting some of the majors' former customers, as well as entirely new travelers.

The intensification of competition between existing airlines would have placed downward pressure on costs to some extent even in the

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By Wright for the Miami News

absence of new entrants, the authors say. The new entrants greatly increased that pressure, however, by streamlining their service offerings and operating with lower cost, often non-union work forces.

Before deregulation the federal government required many carriers to serve small communities using jets and large turboprops. These aircraft were ill-suited for low densities and short hauls, however, and carriers could fill the planes only by adopting "hedge-hopping" routes whose departure times were often inconvenient. Even this mediocre level of service was usually unprofitable and required large and growing federal subsidies.

The 1978 act changed things in two ways. First, it allowed existing carriers to drop unprofitable routes. Second, it made commuter as well as regular airlines eligible to receive subsidies for service to small communities. As larger airlines pulled out of small markets after deregulation, the commuter lines moved in to fill the gap, cutting costs by using smaller turboprop aircraft. The shift to smaller aircraft has made possible higher service frequencies and more convenient schedules, which in itself has often stimulated traffic. Commuters had been making steady inroads into small community service even before, but deregulation has accelerated the trend: "replacement" services have contributed as much as 25 percent to the post-deregulation growth in travel on commuter airlines.

The success of the commuter lines, the authors say, has apparently helped quell one of the major fears about deregulation. Basic air service to small communities has continued and even expanded. In the authors' view, furthermore, the safety record of the commuters is acceptable; the larger and more experienced commuter carriers, who serve over half of all commuter passengers, have a safety record virtually as good as the jet carriers. Moreover, the cost of this service is down both in absolute terms and to the federal treasury. The authors say the 1978 changes had saved taxpayers a total of more than $20 million by mid-1981 and can eventually be expected to save at least $50 million annually—compared with what would have happened if the small community program had continued as it existed before deregulation.

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Bumpers to Bumpers in Court
(Continued from page 12)

tion, does not take place *ab initio;* it occurs in the context of the record established in the original rulemaking. To measure rationality only from the date at which revision began and not from the time the original record was assembled is to throw away useful information and ignore the APA's requirement that a court assess an agency's actions in the light of all the information on the record. An agency's actions should be judged in their entirety.

This does not legalize repeal on demand. Since there is a general principle that agencies should explain changes in policy, the agency may have to give a somewhat fuller explanation of its reasons for the change than it gave for the rule. In addition, the deregulating agency must consider the experience derived from the regulation. If a tentatively adopted regulation has proved undeniably successful, overturning it may no longer fall within the agency's range of discretion, even though failing to enact it would have.

The second major issue in the case was how much detail an agency has to put forward to support its conclusions. Some regulatory reformers have long complained that judges are too deferential to the putative expertise of the agencies. (Recall that the Bumpers amendment would have removed the statutory presumption of agency expertise.) The bumpers court accepted some challenged assumptions that the agency acknowledged were based on the engineering judgment of its staff. The reason is straightforward. Generalist judges cannot uncover glitches in these technical agency assumptions; they must rely on the parties, which presumably have both the access to technical expertise and the will to challenge agency assumptions, to do so for them during the proceeding.

This does not signal an attitude of blind judicial deference, since the court accepted the assumptions only after making sure that the parties had had a chance to object to them during the rulemaking. It does mean that intervenors must bring forth their best arguments in the public rulemaking, rather than holding them back for a court appearance.

The appellants also argued that many congressional sponsors of the Cost Savings Act were on record as indicating that they expected the statute to justify a five mph standard. This legislative history, the appellants maintained, should be a controlling sign of congressional intent. The court found this argument "luminescently invalid."

The legislative veto case made it clear that Congress can act only by passing legislation. Thus, if comments by individual members of Congress can have any effect, it must be because they illuminate what Congress as a whole meant by the text of the legislation it passed, not because they indicate how the individual legislators would like the agency to administer the legislation. The first bears on legislation; the second bears on the execution of legislation, which belongs squarely in the executive branch. To be sure, the agency will want to consider the will of members of Congress as part of its *political* deliberations, since members of Congress can influence executive policy through oversight hearings and in many other ways. But Congress's opinions on executive policy lack the force of law that attaches to congressional enactments.

Much of what passes as "legislative history" suffers from the same practical and constitutional infirmities that inhered in the legislative veto: it is easily manipulated by subgroups within Congress as well as by outsiders interested in the outcome, and it tends to blur if not subvert the separation of powers. By limiting legislative history to its proper role of politically pertinent advice, the court follows the thrust of the "bubble case" last year (see "The Bubble Upheld," Perspectives, *Regulation*, May/June 1984).

Finally, the court rejected the charge that the White House had exerted undue political influence over the agency's actions. It noted that in choosing within the range of discretion defined by the statute and the record, the agency is free to consult political factors. So long as the White House does not attempt to push the agency outside those boundaries, its involvement is not only acceptable, the court found, but indeed the way "the system is supposed to work." (In any case, the court noted, it was NHTSA's existing intent to take action that drove the White House announcement rather than the other way around.) Politics—or, if you prefer, voter influence—in regulatory policy making is no longer taboo.

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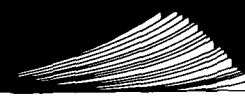

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